

## Better Economic Relations Toward The New Century (The third of four parts) : Reforms in Japan a Success or Not?

By Tsutsumi Tomio

### Serious debate on Japan's current economic situation

In recent years, the economic situation in Japan and its implications for the future of the country have once again become a prominent topic for media debate. This is mainly because Japan's economy has been crippled with little hope for recovery in the foreseeable future, and partly because Japan's exports have recently begun to swell so rapidly that another round of trade friction with the United States looks ever more likely. The conclusions of those observing Japan's situation seem roughly divided into two camps: those who expect Japan to come back as an economic power in the next century after economic structural reforms have succeeded, and less optimistic observers who proclaim the inevitable fall of Japan from economic glory. Also as regards trade friction, one can find a variety of opinions, ranging from views that it is not a good time to have bilateral disputes in the midst of a worldwide economic crisis, to views that it is Japan's international responsibility to absorb imports by stimulating its domestic market and to stabilize the world economy.

Very little of this debate, sad to say, has been based on actual observation of Japan's macro- and micro-economic fundamentals, the underlying economic conditions or the trends visible therein. This article is an attempt to correct this oversight by offering an analysis of the



*Economics-related speech to the new Diet session: Hashimoto stressed that he would "never allow a world financial or economic crisis to originate in Japan"*

economic structures currently in place in Japan, along with remedial policies that are being undertaken to restore the health of Japan's economy.

### Something strange within the last decade

To obtain an accurate picture of the present situation, we must begin with

Photo: Kyodo News Service

the recent past. In the post-war period, Japan experienced over 40 years of favorable economic conditions, but the most recent era has proven far more troubled. It is only within the last decade that the cracks in Japan's economic power began to appear. The true implications of these problems have been coming to a head over the last five years and are making themselves known to all. Let me begin with an explanation of the backdrop to these problems. Internationally, political confrontation between the East and the West has been replaced by strong economic competition on a global basis. Many developing countries are now experiencing rapid industrialization. In the industrialized countries, meanwhile, technological innovation, and particularly the "information revolution," is now occurring at an ever-accelerating pace. Internally, Japan as a society is aging society at a speed which is unprecedented in history, and, along with the slowdown in its economic growth, Japanese people are beginning to be concerned about their future lives in the 'gray age.' As the economic bubble broke, these factors became apparent and gave rise to various problems.

### What are the problems and their characteristics?

To analyze the difficulties which now face Japan in the post-economic bubble era, I would make the following points with regard to the problems that exist

and their characteristics.

1) The problems that Japan is facing now are different from those it faced in the past, since they include many more structural problems; most of which previously had been positive factors in relation to the successful post-war performance of Japan's economy.

2) The problems do not arise from a single factor, but consist of at least three factors.

The first is a cyclical factor, which simply means that a business boom is followed by recession to adjust demand and supply. The magnitude of a recession depends upon the size of the previous boom as shown in the economic cliché "the higher the mountains, the deeper the valleys." Actually, the economic bubble induced

a deep and prolonged recession. Recent fluctuations in the exchange rate for the yen vs the dollar could be categorized as this factor.

The second is a mid-term factor—by which I mean the bad loan problem. Clearly, this problem arose during the economic bubble period, but being different from other cyclical factors, it has much more structural aspects and along with a "Big Bang policy for financial and monetary reform," it has become a unique and serious cause of Japan's economic downturn starting from 1997.

The third is the structural factors—which I will explain in more detail a little later—but at this moment, let me put it this way. The structural problems in Japan are two-sided—the high cost

structure and the system that impedes the creation of new businesses and industries. To change these structures and system, the Japanese Government has been taking comprehensive measures, ranging from deregulation to corporate tax reduction, according to the three-to-five year long program of Economic Structural Reform.

3) As mentioned above, the mixture of factors of short-term and long-term nature in a problem complicates decision-making on what kind of measures should be taken. The question of priority between two policies, domestic demand increase policy or financial deficit cut policies, is one of the most difficult issues for the Japanese policymakers. In a normal situation, market-led economy is

desirable, but in a critical time, the government should take the initiative. The question of priority among policies has taken on added importance recently, as the economic situation grows ever more complicated.

4) So that there should be no misunderstanding, I feel it is important to point out that the problems we face are basically different from those now facing other Asian countries, although some similarities can be found. Japan as a whole is not suffering from any shortage of funds. It could make use of its own funds if this became necessary, in spite of its heavily accumulated financial debt and the fact that it is still suffering from a financial deficit. It is worth noting that Japan remains a strong creditor and even now one of the principal net money-lending countries in

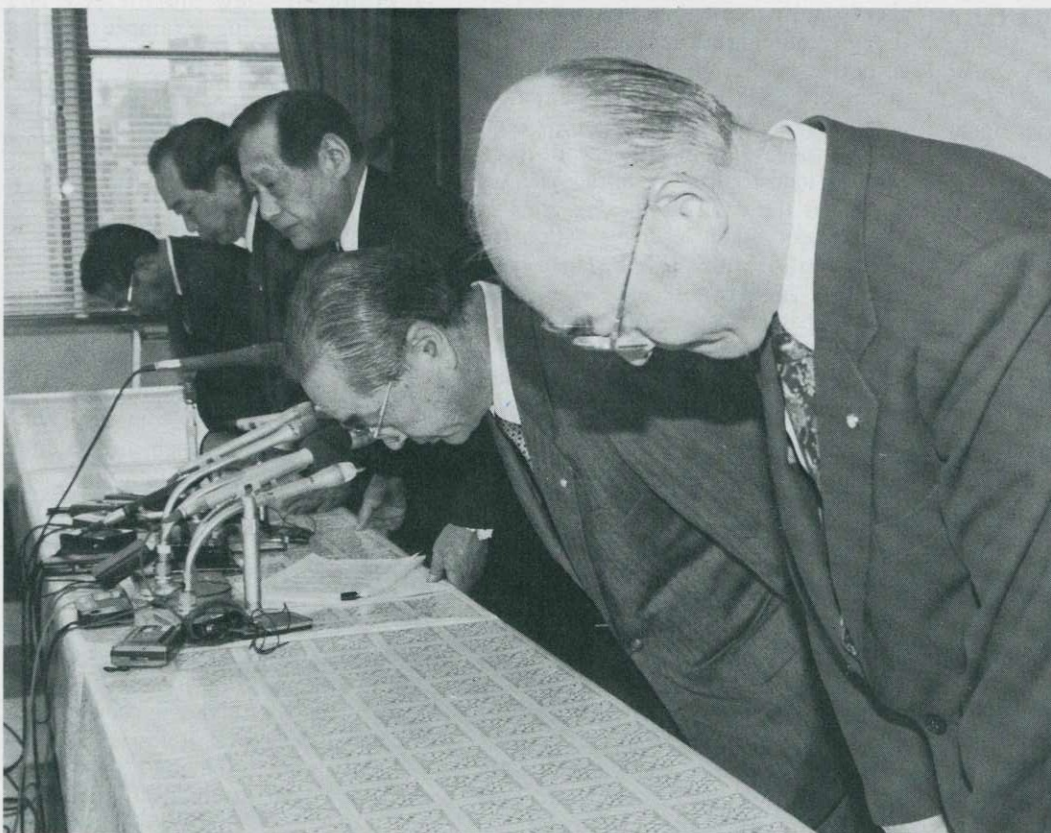


Photo: Kyodo News Service

Burden on financial institutions: failure of the Hokkaido Takushoku Bank due to excessive bad debts brought about a credit crunch phenomenon

international financial circles.

## What actually happened just after the bubble economy?

In my view, there have been two economic crises since the economic bubble broke. Both crises have a lot of similarities, but one can also find basic differences, which I will touch on later.

The first crisis occurred just after the economic bubble period. In 1991-1992, there was a severe fall in economic growth measured by GDP. Recovery since that period has been proceeding at a slow crawl, with nearly zero growth for '92-'94. The slowness of the recovery can be attributed to a combination of factors. As for cyclical factors, one can easily find many demand sectors which decreased drastically as a reactionary fall from the unusual boom during the economic bubble. Private consumption fell, housing investment decreased and private investment plummeted. Along with the strong appreciation of the yen, this had a highly negative impact upon Japan's economy at that time. At this point, it began to be recognized that this recession was quite unique, and failed to follow the pattern of recovery seen after past Japanese recessions. This was the time when we clearly admitted that this recession had problems of a structural nature.

## Structural economic problems

### (1)-high cost structure

Among the inherent structural problems of the Japanese economic system, one of the worst is the high domestic costs faced by Japanese firms. Setting aside high land prices, the dual structure of Japanese industry explains the high cost structure. Industries dealing in tradable goods and services are always exposed to global competition, and consequently, they are highly productive and efficient. On the other hand, costs or prices are higher in the industries of non-tradable goods and services because the scope of their

Fiscal Year	'92	'93	'94	'95	'96	'97
GDP (actual, %)	1.2	0.5	0.6	2.8	3.2	0.1
Current a/c / GDP	3.3	2.9	2.6	1.9	1.4	2.5

competition is basically limited to the domestic market, and moreover they are often well protected by domestic regulations. This is perhaps the most troublesome in the long run, as it pushes domestic firms toward greater levels of foreign investment and decreased domestic presence. Strangely enough, inefficient firms tend to continue operations in the Japanese market, while efficient firms are moving very rapidly to lower-cost countries. This unreasonable exodus of production from Japan is leading to a "hollowing out" of the economy.

High costs arise not only from inefficiency in the private sector, but also from the heavy burden imposed by the government. Taxes, specifically corporate taxes, are another issue that needs to be looked at. Japan's corporate tax rates (around 50%) used to be on a level comparable with those of other industrialized countries. This is no longer the case, as the tax rates in other major countries have fallen (to around 40%) while those in Japan have remained high. These excessive taxes make Japan a less favorable location for business and they are among the factors responsible for the "hollowing out" of the Japanese economy.

In this context, it is crucial to mention Japan's aging society. Japan has the fastest graying population in the world, and by the year 2020, it is projected that more than a quarter of the people in Japan will be over the age of 65. As the ratio of retirees to working individuals increases from 1/5 at present to 1/2 in 2020, the strain on Japan's welfare system will be enormous. Observers already foresee repeated hikes of insurance premiums to avoid a crisis in the pension fund system run by the government. This imposition of a higher burden on workers and corporations will inevitably increase the costs of their

goods and services, which eventually will cause them to lose their competitive edge in the market.

## Structural economic problems

### (2)-system not favorable to new business

As regards the second structural problem, I would like to point out the falling number of new start-up companies, combined with the rising number of firms closing down. This makes it painfully clear that the current economic system in Japan is not at all favorable to new businesses and industries. Taking examples, some domestic regulations form entry barriers for newcomers. A financial system without a well-developed equity market, such as NASDAQ, prevents new firms with innovative technologies from being commercially funded by venture capitalists or "angels." The closed nature of universities and publicly run research institutes makes it difficult for business firms to cooperate with them in R&D activities. More basically, current systems for employment and education often discourage individuals from displaying conspicuous talents which are required for developing new technology and software.

## Eight economic policy packages & structural reform programs

It is the combination of all these factors that led to the introduction of Economic Structural Reform (ESR) in 1995. The concept behind ESR is (1) to crack down on the high-cost structure by abolishing or revising various regulations, (2) to change the current economic system into one favorable to

new businesses and industries, and (3) to help the economy recover steadily enough to make it easier for ESR to be accomplished. Deregulation, corporate tax cuts, rationalization of the welfare system, regulatory reform helpful to business, etc. are concrete steps for achieving ESR.

The Japanese government has been highly active in rectifying these sequential situations—recession, huge trade surplus and economic structural problems. Between 1992 and 1995, eight different economic policy packages were introduced in rapid succession. These packages shifted their weight from anti-recession and trade surplus reducing policies to structural policies.

As for measures relating to the recession and the trade surplus, while the exact details varied, fiscal policy in this period had the central goal of increasing domestic demand. The methods chosen were based on traditional Keynesian policy and Investment & Saving Balance theory (cf. my article in the previous issue); expansion of public investment, promotion of private investment, tax reduction and import promotion, all of which amounted to some ¥65 trillion, as calculated by demand produced. It is also to be noted that during this same period, the official discount rate was lowered six times to as low as 0.5% in order to stimulate growth.

The results of these measures to deal with the recession and reduce the trade surplus are considered to have been successful—at least temporarily—as shown by the following figures.

Measures for dealing with structural problems also include some very meaningful ones, although some observers continue to have doubts about their effectiveness based on past negative experiences in a series of Japanese market opening-up measures. However, who could have expected the drastic foreign exchange control liberalization which will come into effect this coming April? The Large Scale Retail Store Adjustment Law is now considered to be abolished. Corporate tax will be reduced by 3%

this year, which many people consider as the starting year for further tax reduction.

ESR should not be considered as being similar to past market-opening measures, because ESR is reform for our own sake, since without it, we can be very sure that Japan will not be a leading power in the next century.

### The second crisis

In the first quarter of 1997, when Japan's economy did not look so bad, it seemed to be high time to expedite ESR and to strengthen other reforms such as fiscal reform, administrative reforms and financial reforms. Toward the end of last year, a second economic crisis has broken out since the collapse of the economic bubble.

Again, the causes of this second economic downturn consist of three factors. The first and most direct cause is a consumption tax increase, a hike in the social pension insurance premium, and ending of the temporary income tax cut, all of which simultaneously came into effect last April. As a result, private consumption faltered and housing investment plummeted. This present weakness in the economy reminds us of the second, but underlying, factor that Japan's economy is still on the mend and that it is not strong enough to shortly overcome the negative impact of various reforms, ranging from fiscal deficit reduction to financial and monetary system reform (the Big Bang). However, this crisis is featured in a third and most unique factor; combinations of bad loan problems and the Big Bang policies, along with the present economic weakness, which has led to a credit crunch in various sectors. This has begun to put a freeze on economic activity not only in the financial sector, but also in many industrial sectors, and may lead to a vicious cycle.

Fortunately, the government began to address these problems. For the credit crunch, it already announced that it was ready to make use of funds amounting to ¥30 trillion. To stimulate faltering consumption, it already decided to

implement a corporate tax cut (¥1 trillion) as well as a temporary income tax cut (¥2 trillion).

### Hope on the horizon

Unfortunately, both in Japan and abroad, the prevailing views on the Japanese economy are pessimistic. Asia's recent economic crises have only added to these sentiments. However, taking a closer look at Japanese economic fundamentals, it can be noted that it is the largest creditor country in the world and that it is now earning a huge surplus in trade. On top of that, it maintains a top-class high technology base, especially in the field of industrial manufacturing. Most important at this moment, the nature of the current crisis is forward-looking, by which I mean that this economic downturn has stemmed from Japan's challenging efforts in adjusting its economy to the new century. This crisis has been brought about in the process of expediting reforms that in the long run will certainly have positive effects on the economy. In the short run, however, deregulation policy will cause a rise in unemployment, fiscal reforms for cutting the deficit will possibly have a negative impact on the economy, and "Big Bang" financial and monetary reform may lead to turmoil such as a credit crunch. However, the implementation of these policies by Japan is critical from a longer-term point of view. Thus, with the prospect of light at the end of the tunnel, the country will strive to overcome whatever problems and crises appear from time to time on the way to remaking itself.

Simultaneously, I am confident that the direction in which Japan is heading is the right one also in terms of improving economic relations with the U.S.

*Tsutsumi Tomio graduated from the Law Faculty of Tokyo University, served as Administrative Vice-Minister of the Ministry of International Trade and Industry, and is currently a Special Advisor to the Japan Economic Foundation, and also to Sanwa Bank.*