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Putting the Pieces in Place for Japan's Economic Recovery

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SUMMARY Just over a decade ago, the phenomenal economic growth of Japan was admired and even feared. It had pursued a successful strategy of industry upgrading to catch up with the West, maximizing bank-based, state-directed financing. Ironically, the very institutional setup that was required for success eventually resulted in a devastating economic downturn. Japan remains languishing in a state of economic stagnation, but that may change: market forces are now driving Japan to carry out major reforms. A market-oriented business environment is crucial, and thus Japan is being propelled toward deregulation and institutional reform. In particular, its traditionally protected, inner-dependent sector must be opened to competition in order to improve efficiency, and obstacles to direct foreign investment must be eliminated. Although the process is a gradual one that has been further hampered by the slump in the U.S. economy, dramatic changes are in motion, creating promising roles and opportunities for foreign investors as well as potential for Japan to realize a new economic vitality.

Two key market imperatives have been forcing Japan toward the norms of the global economy

Japan is at a critical juncture of dramatic economic change: it must deregulate and open up more fully to global business opportunities and capital inflows. Although progress is slow, the country is in fact changing. That this process of economic transformation has been referred to as the "third opening of Japan" is an indicator of its significance. It follows two other major transformations, the Meiji opening of 1868 and the postwar opening of 1945. These past openings were driven by external pressures, and the current third opening continues this pattern. But the difference is that this new movement toward economic liberalization has been fundamentally compelled by market forces rather than led by the government.

Two key market imperatives have been forcing Japan to bring itself more in line with the norms of the global economy. The first is corporate Japan's pressing need to dispose of excess capacities and distressed businesses while acquiring new managerial skills and expertise in business restructuring. Such skills and expertise can be acquired most effectively through mergers and acquisitions with foreign investors as controlling shareholders. The information technology (IT) revolution has created the second market imperative: deregulation and a more market-oriented business milieu, where entrepreneurship, with its free-spirited ideas, can flourish. Hence Japan's telecommunications industry, once monopolized by Nippon Telegraph and Telephone, has been gradually privatized, and its substantially reduced connection fees have created key access to the Web. Furthermore, Japan's underdeveloped capital markets are being modernized to meet the needs of Net-related ventures.

The government has recently stepped up its campaign to accelerate the third economic opening of Japan. However, the economic logic of the market, driven by global capitalism and the demands of modern information technology, is proving to be far more effective in facilitating reforms than political action has been.

Past Policy

Japan's modern economic history has been one of continuous emulation of, and cautious integration with, the industrialized nations in the West. U.S. industry showed Japan the image of its future. But while Japan absorbed advanced industrial knowledge from the West, it kept foreign companies at arm's length—foreign multinational corporations were not welcomed to run domestic industries. In enlarging and modernizing its own industry, Japan employed a dynamic "infant industry" strategy—substituting domestically produced goods for imports and quickly promoting its own exports. This process entailed government protection and promotion of domestic industries.

Japan's self-directed approach to industrial upgrading seemed flawless and was admired worldwide. Thus Japan caught up with the West and even surpassed it in some industrial technologies. Yet its economy is now in shambles. What went wrong?

The carefully state-orchestrated process that engendered Japan's impressive industrial transformation also rendered its existing economic institutions obsolete. Every economy has its own set of institutions, the arrangement of which largely determines its overall performance during a particular period. But as time goes by, the arrangement becomes dated. This is Japan's current predicament, and two characteristics of Japan's economic institutional setup have been most directly responsible for it.

State-directed, bank-based finance. To pursue its catch-up strategy, Japan maximized bank-based financing instead of financing industrial development through capital markets (equities and bonds). In addition, the government initially repressed capital markets, especially the bond market. Government-fostered dependence on bank loans became the critical mechanism for keeping the price of capital low for corporate Japan, controlling market competition through entry regulations and channeling capital to policy-targeted sectors and projects. This approach would eventually be the crucial factor in generating crisis out of what started as powerful economic growth.

Because the banks were central to government economic policy, they could not be allowed to fail. High-risk investments were encouraged, and the Bank of

A sharp rise in reckless lending set a speculative spiral in motion

Japan (then a policy arm of the Ministry of Finance) always stood ready to bail out major banks at the first sign of difficulty. Moreover, small and even inefficient banks were equally protected under a "convoy system" in which strong banks were obliged to support weaker ones. This made Japan's banks and borrowers more willing to take risks, and the system was effective in promoting large-scale investments in capital-intensive, scale-driven industries, facilitating a swift industrial transformation during the so-called high growth period of 1950–1973.

Ironically, the very success of state-directed, bank-based capitalism eventually undermined the banks' privileged position. Thanks to the low-cost capital supplied by the banks, Japanese companies rarely needed to issue new shares to raise funds. Additionally, because of the practice of cross-shareholding among affiliated firms that were more devoted to long-term growth than to short-term payoffs, companies paid out minimal dividends. After all, they were charged only fixed amounts of interest for bank loans regardless of their profitability. Coupled with rapidly growing profits, corporations quickly accumulated large internal reserves that emancipated them from dependence on banks.

The asset bubble. This rapid change in corporate finance led to the asset bubble of 1987–1990, which was characterized by speculative investments in real estate and stocks. Japan adopted a policy of easy money to combat recession caused by a sharply appreciated yen following the 1985 Group-Five Plaza Accord (an accord under which concerted currency market interventions were carried out in order to weaken the U.S. dollar). The banks became awash in liquidity. At the same time, the government started to deregulate the financial sector, especially with regard to the bond market and loans from abroad. Big corporations in particular began to tap these sources of finance, thereby departing from their banks. Hence, small- and medium-sized manufacturers, housing-loan companies, real estate firms, and construction companies became the banks' major borrowers. In the meantime, banks and their regulators remained both ill-prepared for the changes in the suddenly liberalized financial markets and slow in adopting prudent approaches to asset management. The result was a sharp rise in reckless lending for speculative investments.

Consequently, low interest rates and abundant liquidity fueled rising stock and real estate prices, which in turn became collateral for more loans. A speculative spiral was set into motion. The asset bubble suddenly burst in early 1990 following a rise in the discount rate, which the Bank of Japan controls. The resulting recession accompanied by poor business performance meant banks held increasing numbers of bad loans.

Pork-Barrel Sector

Japan has been able to nurture "infant industries" into competitive ones, but it also has protected many industries from domestic, and especially foreign, competition. This has produced an industrial dualism comprising a highly efficient "outer-focused" (OF) sector, and a secluded, import-averse, "inner-dependent" (ID) sector restricted from inward foreign direct investment (FDI). The OF sector was best represented by automobiles and electronics, while the ID sector included inefficient industries in which local competition was limited, such as agriculture, food and beverages, telecommunications, transportation, wholesaling and retailing, construction, banking, finance, insurance, and real estate.

As the OF sector expanded, Japan's trade balance showed a rising surplus. In addition, the yen sharply appreciated after the early-1970s collapse of the postwar system of fixed exchange rates organized by the International Monetary Fund. Imports should have become cheaper for Japanese consumers, but trade barriers hindered this, and retail prices remained high as exchange gains were simply pocketed by the highly regulated and protected distribution sector. Rather than allowing competitive forces to rationalize the ID sector, the government maintained—and even reinforced through administrative guidance—its regulatory sheltering of the sector. This was because the ID sector was the key political power base and financial source—a "pork barrel"—of the Liberal

Democratic Party, Japan's ruling political party since the early postwar period.

In the face of the yen's rising value and the rising costs of doing business in Japan, both of which were squeezing profits, the OF sector began investing overseas. At the same time, its inner-directed counterpart remained off limits to inward FDI. The result was a lopsided outflow of long-term investment from Japan. In 1990, for example, Japan's inward FDI was a mere $1.7 billion while its outward FDI was $148 billion, 28 times greater. By comparison, at the end of 1991, the United States and the United Kingdom exhibited near balances, while Germany and France showed slight net outflows (1.4 and 1.3 times, respectively).

Japan's unusual FDI asymmetry was naturally interpreted as evidence of the closed nature of Japanese markets, and the Japanese government increasingly came under strong pressure from the United States to open up to inward FDI. In Japan itself, a fear of industrial "hollowing-out" rose as outward FDI continued. Likewise, internal pressure to reform the ID sector grew, especially from the OF sector, beleaguered by the high yen and hence induced to transplant production overseas. The economic stage was set for post-bubble business restructuring and institutional reform, especially for changes in Japan's inward FDI policy.

Foreign investors had a field day buying up Japan's troubled insurance companies

A Changing Economic Scene

Postwar Japan resisted foreign ownership of domestic industries, relying instead on licensing agreements and other non-equity forms of ownership. The result was that while advanced technical knowledge flowed into and was absorbed by Japan, the global and more advanced Western norms of business management and practices that should have accompanied it did not. Japanese-style management and practices were trumpeted as superior, particularly when Japanese automobiles, with their high quality, fuel efficiency, and competitive prices, became the rage in the world market. Japan's "stakeholder model" of corporate governance (in which enterprises exist as much to benefit employees and suppliers as shareholders) was touted as more conducive to corporate growth and competitiveness than the "shareholder model" of American capitalism (in which enterprises exist for the sole benefit of their shareholders).

But in the wake of the stock market crash in 1990, Japanese industry began to lose its hubris and self-confidence. It started to experiment with the "neo-stakeholder model," if not the American-style shareholder model, by paying more attention to the interests of shareholders. Japan quickly realized the fundamental incompatibilities of its economic system, notably its OF-ID dualism, with the vastly changed world. Japan's "lost decade" coincided with America's decade of unprecedented prosperity. Previously unthinkable events began to occur.

Foreign multinationals to the rescue. Beginning in the latter half of the 1990s, signs of fundamental change increased. Yamaichi Securities, Japan's oldest such firm (but bankrupted in 1997), was sold to Merrill Lynch. And in 1999, the Long-Term Credit Bank of Japan, one of Japan's three major quasi-public institutions designed to provide long-term capital to infrastructure projects throughout Japan's high growth period, was bought by Ripplewood Holdings (U.S.) and its affiliates and was renamed the Shinsei Bank. Japanese companies were in dire financial straits, and only foreign companies had expressed interest in acquiring the Long-Term Credit Bank. Politically, the American side treated these deals as examples of Japan's sincerity about opening its financial markets to foreign participation under the program of financial deregulation referred to as the "Big Bang." Second-tier Kofuku Bank and Tokyo Sowa Bank were also quickly purchased by a Texas-based equity fund, Lone Star. Two of Japan's mid-size consumer finance companies fell into the hands of AFCC (a subsidiary of Citigroup, U.S.). Foreign investors also had a field day, as they bought up many of Japan's troubled insurance companies.

In 1999, Renault of France took a 36.8 percent stake in and assumed the management of Nissan Motor Company, Japan's number-two automaker. The company began an impressive turnaround under the French executive Carlos Ghosn, who is popularly known in Japan as "le cost cutter." Only a few years

Japanese Insurance Companies Purchased by Foreign Investors

	Investor / Country	Purchase Date
Nippon Dantai Life	Axa / France	November 1999
Nissan Mutual	Artemis / France	November 1999
Heiwa Life	Aetna / United States	February 2000
Nicos Life	Credit Suisse / Switzerland	March 2000
Chiyoda Mutual Life	AIG / United States	October 2000
Kyoei Life	Prudential / United States	October 2000

before, who would have imagined that this world-class Japanese car maker—whose vehicles were rated higher in quality, reliability, emissions control, and fuel efficiency than any Western-made car—would have to be rescued by French management?

With the onset of post-bubble stagnation, the Japanese automobile industry had to trim its excess capacity. Yet Japanese management was simply not prepared to restructure through ruthless, Western-style cost-cutting measures that would throw tens of thousands of workers out of their jobs. The stakeholder model suddenly became an obstacle. French management, however, quickly moved to reduce Nissan's global workforce by as many as 21,000 (or 14 percent), to close five assembly plants and drop its inefficient suppliers, and to streamline its distribution network by closing 300 Japanese dealerships over three years. Similar restructuring efforts are under way at all other Japanese automobile makers that are controlled by foreign multinationals, including Mazda, Mitsubishi, and Fuji Heavy Industries. It is indeed a sea change, now that Prime Minister Junichiro Koizumi specifically has endorsed Renault's takeover and impressive turnaround of Nissan as an exemplary way of restructuring Japanese businesses in this age of globalization.

Japanese management was not prepared to restructure through ruthless, Western-style cost-cutting measures

Consequences for Japanese companies. Japan's distribution sector (wholesaling and retailing)—once off-limits under the Large-Scale Retail Law that protected small, mom-and-pop stores in the ID pork-barrel sector—is now being crowded in by a number of large-scale distributors and retail stores. While competition comes from both domestic and foreign sources, it is particularly keen from foreign multinational discount chains, such as Toys 'R' Us, Office Depot, The Gap, Boots (a British drugstore chain), Sephora (a French cosmetics retailer), Starbucks, Carrefour (a Paris-based grocery retailer), and Costco Wholesale.

Japan's telecommunications industry, only recently deregulated, has quickly attracted Vodafone Group and British Telecommunications (both of the U.K.) as new shareholders in J-Phone Group, one of Japan's three major wireless phone companies.

Throughout most of the 1990s, annual FDI in Japan had hovered around $5 billion; then, in 1998, it nearly doubled, exceeding $10 billion for the first time. In 1999, FDI inflows reached $21.5 billion and in 2000, $25.8 billion (based on statistics for the fiscal year, which ends on March 31). Inward FDI is estimated to exceed $32 billion in 2001. The suddenly rising FDI in Japan is boosting the presence of foreign business interests. They now form an increasingly effective lobbying group that is pressuring the Japanese government to create a more business-friendly environment through deregulation and by rewriting Japan's archaic commercial codes. It is no coincidence that Howard Baker, the U.S. ambassador to Japan, called for U.S. opportunities to invest in Japan that would be comparable to Japan's freedom to invest in the United States.

These unprecedented investments are a fresh breeze in the otherwise stale atmosphere of Japanese management, not only for foreign-acquired firms but also for the economy at large. The floodgates are open, and FDI in Japan is rising sharply, especially in mergers and acquisitions, as Japanese companies struggle to unload unprofitable non-core business operations. New accounting rules that conform to outside norms allow companies to be bought and sold more easily, and a new mergers and acquisitions market is emerging, one already dominated by Western dealmakers such as Goldman Sachs, Merrill Lynch, and Morgan Stanley Dean Witter. All in all, foreign investors are looked upon as agents of business restructuring and institutional change. Ironically, they are increasingly active in the same ID-sector industries that were so long sheltered from competition.

However, many moribund local companies, especially politically connected construction and property firms in the ID sector, survive on life-support provided through Japan's still extravagant banking system, which continues to give loans and forgive debt at enormous cost to taxpayers. The Japanese public seems finally to have had enough of these inefficiencies. Seeing Prime Minister Koizumi as a maverick capable of instituting reform, it has placed an unusually high degree of trust in his government. It remains to be seen, nevertheless, how earnestly and effectively Koizumi will be able to honor his campaign pledges in the face of inevitable opposition within his own party. Meanwhile, as Japan's financial sector burns, foreign investors find increasing numbers of gradually sacrificed Japanese companies for sale.

The Japanese public sees Koizumi as a maverick capable of instituting reform

The Imperative of the IT Revolution

The advent of the IT revolution has thrust Japan abruptly into a new stage of growth that intensively employs IT and intellectual capital. This new stage is characterized by production of "abstract" or "conceptual" goods (such as readily accessible information and transactions on the Web), whereas in the earlier stages of catch-up growth more tangible inputs were intensively employed to produce physical goods.

An IT-driven economy is a creature of America's free-market system and its equally freewheeling stock market. It is a long-term outcome of deregulation, trade liberalization, a flexible labor market, and coalescing technological changes. It took the United States about two decades to establish an IT-driven economy. In particular, capital markets (venture capital, equities, IPOs, and mergers and acquisitions) have been an indispensable ingredient of the unprecedented U.S. economic boom. Because the IT revolution emerged as a result of drastic deregulation and free-market play in the United States, its spread to Japan has already significantly affected Japan's system, especially in the areas of telecommunications, finance, and distribution. Along with FDI in Japan, the IT revolution is providing an autonomous, market-driven impetus for Japan to deregulate its business milieu so as to promote entrepreneurial Internet ventures.

Most interestingly, the Net revolution will, for two reasons, have its greatest impact on Japan's once heavily protected ID sector. First, such a revolution requires deregulation and free-market transactions. Second, an application of IT enhances transactional efficiency and productivity. Therefore the more archaic, distorted, and inefficient an industry is, the greater the potential gains from Net application, and hence the faster the potential productivity growth. Japan has a huge backwater of still regulated and protected industries in its ID sector that are now beginning to open up for global competition through trade and investment by multinationals.

Cellular phones. One prime example of this process is Japan's burgeoning cellular phone (wireless telecom) market, which now boasts the world's largest number of subscribers (27.6 million as of October 1, 2001) to NTT DoCoMo's wireless Net access service (popularly known as "i-mode," the world's most advanced mobile data service). This domestic advantage gives Japan a head start in the race to introduce third-generation (3G) cellular service. On October 1, 2001, DoCoMo unveiled the world's first 3G mobile phones with a built-in camera for the videophone function, though initially limited to the Tokyo metropolitan area. There may be some technical glitches in any brand-new product and services, but the rest of the global telecommunications industry is keenly interested in DoCoMo's move.

U.S. pressure to deregulate resulted in Japan taking the forefront in the global race to a wireless Internet

A surprisingly little-known fact, however, is that the United States forced Japan to deregulate its mobile phone market in 1994 to support the expansion of American telecom multinationals into the Japanese market. Until then, Japanese citizens were not even permitted to own personal cellular phones. Thanks to the U.S. pressure to deregulate, Japan finally opened up this market and serendipitously leapfrogged to the forefront in the global race to a wireless Internet.

Stock options. The IT revolution is also compelling corporate Japan increasingly to seek financing through the capital markets, American style. For example, stock options for executives and employees used to be uncommon because of restrictive regulations. Although deregulation in 1997 eased the use of stock options, more should be done because current law imposes excessive tax penalties on foreign multinationals that use these options to lure talented workers for new Net-related ventures. Currently, the stock options given by the multinationals' parent companies to their local employees are subject to both capital gains and residential taxes, which may be as high as 50 percent. Employees of companies listed in Japan are taxed at a rate of 25 percent for stock options earnings. The foreign multinationals' local lobby is now urging the Japanese government to level the field by straightening out the tax codes. In addition, they are pressuring the government to allow foreign multinationals to be able to use stock to finance mergers and acquisitions deals. Stock swaps are more frequently used in the West than cash or exchanges of cash-plus-stock, and, after all, two new stock markets devoted to financing IT ventures were opened in the summer of 2000: Nasdaq Japan and the "Mothers" (Market of High-Growth and Emerging Stocks) exchange.

Toward a New Economy

It is true that America's New Economy has lost its financial luster with the high-tech stock meltdown (which destroyed $5 trillion in paper wealth), rampant failures of dotcoms, and the shaky telecom industry. But during the period of 1996–2000, the U.S. economy did enjoy considerable growth in labor productivity—a 2.5 percent average rate, something not seen since the 1960s. The New Economy was certainly not just a bubble that burst. The adoption of IT throughout the economy and the increased efficiency with which IT products are themselves produced are credited for this productivity growth. Japanese industry cannot expect to replicate a financial boom related to IT (a high-tech bubble it would like to avoid), but it is in a position to reap the benefits of real productivity improvement.

Japan has long been known as a skilled emulator, as demonstrated by its successful industrial restructuring. Now, the advent of the Net age is providing another unique opportunity to catch up and, sensing the opportunity, Japan has again begun to mobilize itself. In September 2000, its newly formed twenty-member Information Technology Strategy Council, chaired by Sony's president and composed of other notable captains of industry such as Toyota Motor Corporation, Softbank, and IBM (Japan), announced an ambitious goal: to overtake and surpass the United States in the Internet economy in five years. To this end, the Council urged the government to dismantle all institutional obstacles to the growth of a New Economy (i.e., burdensome regulations). Japan has a solid production base of Internet components, including telecom equipment, fiber optics, and digital goods. Another round of catch-up has begun. Indeed, Japanese frustrated by a lost decade of growth recognize the promise of revitalizing their economy through deregulation and criticize the government for the slow pace of reform. This is why Koizumi's pledges for reform gave him such unprecedented popularity among voters.

Unfortunately, however, the timing of Japan's current reform is not propitious. The U.S. economy is in a slump, adversely affecting the rest of the world, but especially the export-oriented Asian economies. The Bank of Japan's expansionary monetary policy is helpless, given the fact that the short-term interest rate (equivalent to the Federal Funds rate) is already near zero. It cannot stimulate the economy so easily by further lowering the interest rate.

The timing of Japan's current reform is not propitious

The reform process, whether driven by market forces or by political act, is painful because it necessarily entails a rise in business bankruptcies and unemployment as distressed firms in the ID sector are removed from life-support and market competition increases. It will be even more painful in the wake of the current global economic slowdown. In times of hardship, politicians are most likely to protect their constituents' parochial interests—notably in their pork-barrel sector—rather than long-term national interests. In the meantime, the weakened economic conditions worldwide are also vitiating the forces of global capitalism and the pace of the IT revolution. Hence, Japan's reform is expected to be hampered at least for a while—until the world economy recovers from its current doldrums and uncertainties.

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For Further Reading

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