Richard Katz

Helping Japanese Economic Reform

It stands as a monument to bad timing. One month before Japan's bubble popped on New Year's of 1990, one of America's most brilliant economists wrote:

> An Asian economic bloc with Japan at its apex ... is clearly in the making. This all raises the possibility that the majority of American people who now feel that Japan is a greater threat to the U.S. than the Soviet Union are right.

Today, that economist, Lawrence Summers, is U.S. secretary of treasury. What keeps him awake at nights now is not the mythical threat from a Japan that is supposedly too strong, but the all-too-real consequences of Japan being too weak. The point is not to single out Summers, but the contrary. The fact that someone as intelligent as Summers was temporarily taken in indicates the degree of hysteria then gripping the United States.[1]

Today, the opposite mistake is being made. In much of Washington, Japan is simply off the radar screen. There are even some voices suggesting we "let 'em stew in their own juices." Such sentiments are shortsighted. The welfare of the United States and the international community at large is seriously damaged by the ills emanating from a weak Japan.

The greatest damage is not seen bilaterally but in the U.S.-Japan-Asia triangle. Japan's weakness was a major contributor to the 1997 financial meltdown in Asia, which, in turn, provoked the scariest global financial crisis in decades. For one thing, Japan's recession led to a 15-percent cut in its imports from Asia between mid-1997 and mid-1998. Added to that was the

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weak yen. Convinced in 1995 that economic stagnation posed a threat to the Japanese banking system, the U.S. Treasury helped Tokyo weaken the yen to stimulate Japanese exports. The collateral damage was a steep drop in the export earnings of countries such as South Korea that directly compete with Japan. Finally, due to their own shaky finances, Japanese banks were less willing than others to partially write-off and/or roll over short-term loans. Japanese banks withdrew half of their loans to Asia from mid-1997 to the end of 1999, twice the 22-percent withdrawal by U.S. and European banks.[2] Japan's malaise did not cause Asia's catastrophe but did make it significantly worse.

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Japan's rejuvenation is critical to Asia's continued long-term industrialization. That industrialization is built on exports of manufactured goods. Until now, Japan has not provided much of a market. As of 1990, Japan bought only 5 percent of Malaysia's manufactured exports compared to 28 percent by the United States; 15 percent of Korea's as opposed to 32 percent by the United States; 9 percent of China's against 23 percent by the United States; and 14 percent of Thailand's versus 28 percent for the United States.[3] Since then, Japan's manufactured imports have improved, but the bulk of the increase is from Japan's own affiliates in Asia (e.g., black and white TVs from Matsushita's overseas plants). Since America's absorption capacity is limited, Asia's continued progress will be held back unless Japan imports more.

Fortunately, Japan can do well for itself by doing good for Asia. Importing more competing goods—such as steel from Korea, petrochemicals from Singapore, or finished wood products from Indonesia—will provide the competitive pressures needed to give Japan a productivity boost at home.

As Indonesia's dicey transition emphasizes, Asia's economic health has clear security ramifications. Beyond that, as long as Japan is economically stagnant and politically gridlocked, it will be more focused on its internal problems than on playing a role on the global stage. Yet, to cope with new concerns in Asia—particularly the integration of a rising China—the United States needs an equal and politically engaged partner, not an unsinkable aircraft carrier and open checkbook.

Bruce Stokes of the Council on Foreign Relations has argued that the United States has little stake in Japan's recovery unless it entails greater openness to imports and foreign direct investment (FDI).[4] In my view, Japan will find it very hard to institute reform without allowing more imports

and FDI. The latter help break down the cartels and other anticompetitive practices now stifling growth. Hence, even America's narrow commercial interests give reason to support reform. In the long run, however, the broader interests in a healthy ally loom much larger than a few more dollars in sales.

The real question for U.S. policymakers is not the criticality of Japanese revival but whether there is anything the United States can do about it. Can the United States influence the likelihood, pace, and shape of reform in Japan, or must it simply watch and wait as the drama unfolds on a purely Japanese stage?

Clearly, the success or failure of reform will be determined in Japan, not in the United States. As Bowman Cutter, deputy director of the National Economic Council in the first Clinton administration, stated, "The U.S. has no power to force the world's second largest economy to move in a direction it does not want to go."[5]

But that is just the point. Reform is a direction in which Japan will increasingly want to go—because that is where it has to go. Without fundamental reform, the economy cannot return to lasting health. That is why we see reform advocated more often in both elite circles—such as bureaucrats, politicians, academics, multinationals, and the media—as well as the more popular circles such as urban, salaried voters. Yet, many vested interests—such as construction firms, mom-and-pop retailers, and farmers—would be hurt by reform. Increasingly, ministries and the ruling Liberal Democratic Party (LDP) are internally divided between modernizers and old-fashioned "mother hens" for the vested interests. We now see open debates between these forces in the Diet and on television.

In many cases where the two sides are stalemated, judicious action by the United States can help tip the balance. As one former officer at the U.S. embassy in Tokyo, said, "U.S. influence in Japan is like currency intervention. Large parts of the time, it is impotent. But at critical moments, it can help turn the tide."[6]

To understand how the United States can help tip the balance requires viewing Japan through analytical paradigms that make its potential leverage visible. Two premises should guide U.S. efforts in this area:

- Japan's economic revival and political stability requires fundamental reform; and
- the need for reform has changed the policymaking process, primarily by creating fissures in what used to look like "Japan, Inc."

Understanding these new conditions is critical in order for U.S. action to be effective.

Political Stability Requires Economic Reform

The rate of growth that Japan requires for political stability cannot be achieved without fundamental reform because the obstacles to growth are woven into the very fabric of Japan's political economy. Patterns that worked brilliantly in Japan's "catch-up era" are now obsolete and must be altered. Of course, Japan needs macroeconomic stimulus, but that is like saying a car needs tires without noting it could also use an engine. The engine is institutional reform.[7]

Growth is hobbled by pervasive, private, anticompetitive practices supported by regulations that protect the inefficient. The result is a dual economy of super-efficient export industries side by side with super-inefficient domestic industries. Exporters facing stiff competition overseas have no choice but to be efficient. Conversely, anemic competition at home leads to atrophy. In food processing, for example, productivity is one-third of U.S. levels. Yet, more people work in food processing than in the automotive and steel industries combined.

The dual economy functioned only as long as the exporters propped up their domestic brethren. The high prices Toyota pays for inputs like glass, steel, and electricity are disguised subsidies. By the late 1980s, the burden had become unbearable. The exporters fled offshore. Today, Japan produces more cars and consumer electronics abroad than at home. As the efficient sectors "hollowed out," the productivity of the entire economy fell to the pace of the laggards. Today, without reform, the fastest long-term growth Japan could sustain at full capacity is between 1 and 2 percent per year.[8]

To make matters worse, Japan has trouble sustaining full capacity without artificial life-support. The same cartelization that creates inefficiency also leads to "economic anorexia"—a chronic inability of private demand to consume all that Japan produces. As economies mature, they typically move from investment-led demand to consumer-led demand. Not Japan. Corporations still rake in lots of cash, but they no longer plow it all back into the economy via investment. Nor do they return it to household worker-savers. Inflation-adjusted household income—wages, interest, and dividends—has actually fallen as a share of gross domestic product (GDP) since 1980. Too much savings by corporations means too little spending by consumers. For example, high prices mean families must spend 20 percent of their income for food, compared to 10 percent in the United States. Think of the purchasing power liberated for new houses and appliances if food prices could be reduced due to competitive pressures from either imports or from more efficient foreign producers starting up operations within Japan.[9]

In the past, Japan made up for economic anorexia via the artificial demand

of huge budget deficits, mushrooming trade surpluses, and periodic surges of private investment fed by low interest rates. By the 1990s, the legacy of these past "solutions"—excess capacity and bad bank debt—became new obstacles to growth. Today, despite budget deficits approaching 10 percent of GDP and interest rates close to zero, Japanese growth is weak.

The dilemma is that the very things that hobble growth also function as pillars of Japan's political system. Corporate collusion, protective regulations, and high prices serve as a covert social safety net in a nation without a solid governmental safety net. By shoring up moribund firms and industries, these practices sustain millions of "make work" jobs that would have been eliminated in a more competitive environment. They also provide disguised income transfer from the efficient to the inefficient. Much of the money and voter base of the LDP relies on such practices. Hence, the very things that make structural reform economically necessary also make it politically difficult.

> In much of Washington, Japan is simply off the radar screen.

Yet failure to reform is also destabilizing. Some societies could safely chug along at a snail's pace and still maintain political stability. Not Japan. Many of its institutions break down without a certain minimal level of growth—from high corporate debt and lifetime employment to seniority wages and social security for the growing ranks of retirees. Income transfer through high prices collapses in an era of deflation.

When sales are stagnant, firms are impelled to cut labor costs. One million workers have lost their jobs, mostly at smaller firms. Rather than transferring workers to new, more productive jobs, workers are told they can keep their current jobs if they accept wage cuts. Hence, total real wages have dropped 3 percent since 1997. Falling wages translate into anemic consumer spending. So, each firm's action to cut its costs ends up cutting sales at other firms. It is not only employed workers who experience the downturn. Retiree income from pensions and savings are reduced by ultra-low interest rates. The consumption tax, created to support the elderly, caused the LDP to lose two Upper House elections (1989 and 1998) and helped trigger the 1997–1998 recession. Without better growth and productivity, the consequences of aging can only get worse. Today, there are five workers for every retiree. In 25 years, there will be only two.

Caught in this dilemma, the LDP unsuccessfully tries to muddle through. Neither pushing through reform nor simply stonewalling, it waffles and wavers.

An End to the Black Box Paradigm

What all this means is that Washington's traditional operational paradigm toward Japan no longer works. For decades, Washington implicitly viewed Japan as a monolithic unitary decisionmaker. Although most analysts disparaged the caricature of "Japan, Inc.," in practice, U.S. officials often acted as if Japan was governed by an elite so unified in purpose that Japanese policymaking was not subject to the political and interest group conflicts that grip most modern societies. From this vantage point, Japan was a kind of black box. Carrots and sticks were used to influence Japan as a whole, but policymakers seldom felt the need to look inside the box. Of course, on a tactical level, Washington regularly relied on individual politicians to break through bureaucratic logjams. But, on the strategic level, the monolithic paradigm usually held sway.

The black box paradigm worked well enough in the past. Except for two periods totaling about two years, the same party—the LDP and its predecessors—has ruled from the end of World War II until today. Indeed, Japan is the only industrial democracy where such one-party rule still prevails. The LDP's "catch-all coalition" encompassed both the efficient and inefficient sides of the dual economy. The "iron triangle" of the LDP, powerful ministries, and big business—many of whose individual leaders went to school together and often crafted marriage alliances—did comprise a fairly tight governing elite.

Yet, this apparently harmonious consensus rested on conditions that no longer exist. What made the catch-all coalition possible was economic growth high enough to pay off any significant "losers." Today, however, the economic pie is too small to share a decent slice with everyone. Conflicts of interest are mounting. The banks need low interest rates, but they hamstring retirees and bankrupt insurance companies. In the past, profits and wages grew in tandem. Now, firms say profits and jobs must come at the expense of wages. Exporters need reform to lower the cost of inputs, but raising the efficiency of backward sectors would temporarily eliminate millions of jobs in a nation without a good social safety net. Indeed, due to pressure from inefficient sectors, a caucus comprising the majority of the LDP Diet delegation is trying to roll back even the mild deregulatory measures already instituted. Yoshiro Mori—prime minister as of press time—was a member of this caucus, formally titled the Forum to Reconsider Deregulation.

The LDP's dilemma is inescapable. Any genuine effort at reform would tear the party apart, yet failure to enact reform has the same effect. Either way, large parts of its base will be alienated.

The result is trench warfare between reform and the status quo. On the one hand, changes inconceivable a few years ago are now beginning in the

areas of finance, corporate strategy, telecommunications, retail, and FDI. At the same time, there is irresistible political pressure to slow this restructuring, or at least shield firms and employees from its consequences.

Take the case of loans to firms that are no longer creditworthy. The effort to remain solvent is forcing banks to reduce financial life support for these moribund firms. On the other hand, the government has already issued credit guarantees totaling more than 42 trillion yen ($400 billion), so firms can get new loans, and has authorized enough money to raise the level to 50 trillion yen. That's equal to 10 percent of GDP, 20 percent of all loans to small business, and 10 percent of all outstanding bank loans. When these firms default—in one month, 11 percent of all bankruptcies were by firms with such guarantees—the government takes the hit. The balance sheets of the banks look better, but nonperforming loans held by the government soar. The dual economy becomes even more dualistic, and government debt grows to the stratosphere.[10]

This basic conflict has already eroded much of the LDP's power. It lost its majority in the Diet's Upper House in 1989 and has never regained it. Then in 1993, it split and fell from power. It did regain power a year later, but it has never again been able to win a majority on its own in the more powerful Lower House of the Diet. In this year's elections, the LDP garnered a dismal 29 percent of the vote in the proportional representation part of the election (where 180 out of a total of 480 Diet seats are chosen by voters designating their favorite party). Hence, the LDP has only been able to rule in coalition with an unstable and ever-changing set of former opposition parties. The coming years will likely produce another split, or series of splits, in the LDP. This rocky and prolonged transition from the one-party state to competitive politics is an unavoidable part of the process of reform.

What Can the United States Do?

The first rule for the United States is do no harm. Policies based on the obsolete unitary decisionmaker model have often led to inadvertent U.S. support for the status quo.

In the early 1990s, the Bush administration pressed Japan to increase public works spending by $500 billion over 10 years. The objective was to stimulate Japan's domestic economy, elevate its imports, and thereby reduce its trade surplus. As reformist officials at the Ministry of International Trade and Industry (MITI) pointed out, however, this move "gave an allowance to the construction *zoku* (caucus)." It increased the financial resources and political clout of the construction industry and its LDP representatives—a bastion of corruption and antireformism.[11]

Then, in 1993, when an anti-LDP reformist coalition government under Prime Minister Morihiro Hosokawa came to power, the Clinton administration hailed its emergence. Yet, Washington's harsh tactics during the Framework trade talks ended up pushing Hosokawa into a nationalistic-defensive alliance with the antireformists.

Admittedly, it is impossible to avoid all trade-offs between U.S. interest in reform and interest in other vital goals such as macroeconomic stimulus, trade issues, or security cooperation. But a better job can be done of taking such trade-offs into account (e.g., pushing fiscal stimulus through individual tax cuts rather than public works).

The need for reform has created fissures in what used to look like 'Japan, Inc.'

A third example came in the fall of 1998 during Japan's banking crisis. At that time, an alliance of the opposition Democratic Party and urban-based LDP reformers, such as Yasuhisa Shiozaki, came up with very sensible proposals to recapitalize the banks with strict conditions. In contrast, Prime Minister Keizo Obuchi proposed handing out cash with very few meaningful conditions. Three key conflicts intersected in this struggle: (1) forcing the banks to clean up lingering bad assets (which drag down economic growth) versus handing the banks money so that they could continue making loans to deadbeat firms; (2) the national interest versus the special interests (as the Democrats pointed out, Obuchi's scheme to bailout the bankrupt Long-Term Credit Bank (LTCB) would have used city dwellers' tax money to salvage the investments of LDP-allied farmer cooperatives in an LTCB subsidiary, Japan Leasing); and (3) rule by the elected Diet versus the bureaucracy. Using open debate instead of backroom deals, the Diet seized control of the issue. It forced Obuchi to accept some conditions for bank loans, removed jurisdiction from the incompetent ministry of finance, and created a new agency, the Financial Supervisory Agency (FSA). Initially at least, the FSA proved to be far more aggressive than the finance ministry in making the banks face up to their bad debts.

At that very moment, the Clinton administration decided to shore up Obuchi against the reformers! At a photo-op during a summit, Clinton compared Obuchi's critics to the Republicans trying to impeach him. Treasury Secretary Summers's speeches focused on rushing money to the banks, while talk of conditionality became *pro forma*. When Obuchi bragged in the Diet of Clinton's support, the reformers were demoralized. The reformers still managed to establish a beachhead, but momentum stalled. As one Bank of

Japan official put it, "The window of opportunity on further reform closed." Indeed, Ichiro Ozawa, the leader of the Liberal Party, defected from the opposition coalition and allied his party with Obuchi. To be sure, the U.S. stance was only one factor, but it did help tip the balance—in the wrong direction.[12]

Once the money for the banks was passed, the U.S. Treasury again raised the issue of conditions, but doing the right thing at the wrong time does little good. With the big banks out of immediate danger of failing, the LDP felt little pressure for the kind of reform that the U.S. Treasury now sought.

Partly, the U.S. stance was driven by fear that political squabbles would delay injection of government money into the banks. That risked the chaotic failure of several big banks at a time when both Japanese banking and global finance were in precarious shape. Treasury officials misjudged the situation, however, thinking the options came down to Obuchi's "money with no conditions" or the Democrats' original "no money under any conditions." They failed to appreciate how the Democrats' alliance with LDP reformers was moving it toward "money with conditions." More nuanced memos sent from the U.S. embassy in Tokyo (where opinions were also divided) failed to register. A second factor was an internal debate in the U.S. government between a "recovery first, reform later" faction and a "both recovery and reform now" faction. The first group, which included Summers, argued that Japan was then too weak for radical reform, especially since reform's initial effects would be deflationary. Finally, Washington feared that continued fighting could force new elections and that the opposition was incapable of forming a government. It feared that the only result would be more delay at a time when speed was of the essence.

It is understandable why stability was Washington's first goal. The fall of 1998 was a very precarious time in global finance, but it was a mistake in judgment caused by a mistake in perception. Gripped by the unitary decisionmaker model, U.S. officials failed to see the significance of the banking debate for the politics of reform. Shoring up Obuchi was like shoring up Konstantin Chernyenko in the waning days of the Soviet Union. In any case, aiding LDP rule at a time when Japan is moving toward competitive politics is an outdated vestige of Cold War thinking.

Washington is in serious danger of backing the wrong horse again today. In its concern with macroeconomic stimulus, the United States' "recovery first, reform later" faction has been supporting the finance ministry's efforts to get the Bank of Japan to adopt "inflation targeting" or to directly underwrite government debt. In reality, when it comes to genuine monetary stimulus, the bank is already doing just about all that a central bank can do by reducing short-term interest rates to zero. What the finance ministry and

LDP really want is for the bank to bail out the LDP's supporters in the dark side of the dual economy. They want it to print funny money to finance schemes such as the loan guarantee fund for uncreditworthy companies. For Washington to support the finance ministry against the bank is once again to support the old regime against reformers, to sacrifice structural reform on the altar of short-term stimulus.

Worse yet, Washington seems to have little sense that this is the effect of its posture. Because the black box viewpoint does not factor in the institutions through which policies are implemented, it fails to see that disputes over seemingly technical monetary issues have far-reaching political-structural ramifications.[13]

There is yet another adverse consequence of the black box paradigm. Its operational corollary—"carrots and sticks"—leads Washington to oscillate between excessive stridence (the stick) and excessive conciliation (the carrot). In 1997 and early 1998, Washington pressed Japan to apply fiscal stimulus and to inject public money into the banks. The advice was right, but Washington's tone came across as hectoring. When Obuchi threatened a nationalistic backlash, Washington reversed course. Alleged conciliation toward Japan turned into support for Obuchi. Looking inside the box would help avoid either extreme.

Economic Gaiatsu: Seeking Allies

Beyond avoiding harm, the United States can make positive contributions to accelerate reform. It is not a question of choosing personalities or parties, but policies and processes.

What the United States brings to the table is, ironically, its own desire for greater market access. In a host of countries, globalization has proven to be a major ally of reform. Imports and FDI act as a battering ram against cartels and protective regulations. As economists Jeffrey Sachs and David Warner emphasize,

> The international opening of the economy is the *sine qua non* of the overall reform process. Trade liberalization not only establishes powerful direct linkages between the economy and the world system, but also effectively forces the government to take actions on other parts of the reform program under the pressure of international competition.[14]

Everett Ehrlich, former under secretary of economic affairs, captured it best when he said, "We have too often thought of these [market opening] policies as unilateral concessions we demand of the Japanese. It is time to think of them instead as tonics for what ails Japan."[15]

Analysts have long talked of *gaiatsu* (foreign pressure) in political terms.

Reformers in Japan have often used U.S. pressure to create changes that Japan's one-party state could not achieve on its own. Indeed, in the current negotiations with the Ministry of Posts and Telecommunications over access fees to the Internet—where the ministry supports the Nippon Telegraph and Telephone (NTT) monopoly—one MITI official told me privately, "We hope the U.S. succeeds against NTT." Imports and FDI are, in effect, veiled economic *gaiatsu*. It is unfortunate that economic *gaiatsu* is necessary, but it does seem unavoidable.

Washington's traditional operational paradigm toward Japan no longer works.

A simple example of economic *gaiatsu* came in 1992 when Houston-based Compaq Computer started heavily discounting the personal computers it shipped to Japan. This raised the sales of Compaq and other foreign-owned PC firms, but the larger impact was that it induced Fujitsu, Japan's second-ranking PC maker, to launch a price war against the leader, Nippon Electric Company, which owned a 53-percent share of the market. Within months, PC prices dropped by a third, and NEC's share fell below 40 percent. Foreign players outside the cozy club can often change the way that powerful Japanese insiders operate.

Until recently, even reformers in Japan commonly failed to see imports and FDI as an ally. That is beginning to change. In 1996, the Economic Planning Agency declared, "An increase in imports would stimulate incentives to raise productivity of domestic industries." Now, some sections of MITI are getting the point. In its latest White Paper on International Trade, MITI argues that a series of bilateral free-trade agreements with countries like Singapore and South Korea could put pressure on Japan's less competitive service industries, such as port operations and telecommunications.[16]

The difficulty is MITI's internal division. Some bureaus concerned with the economy as a whole are often quite progressive in their thinking, while "vertical" bureaus supervising individual industries still see their proper role as "mother hens." It is the latter that U.S. trade officials usually encounter in negotiations.

One MITI official in his mid-40s noted how long it took MITI to overrule its own Natural Resources Agency and lift restrictions on imports of petroleum products. Once it did, gasoline prices fell 25 percent. Now, he noted, MITI is trying to reduce sky-high electricity prices. "It's too bad we can't import cheaper electricity." The real news, he said, was not that his views were still a distinct minority, but that they were becoming more common among younger officials who had been posted overseas.[17]

Propagating the notion of imports as an ally of reform is still an uphill climb. By contrast, the benefits of FDI are now widely appreciated—mainly because of rescue operations like Renault's takeover of Nissan or Ripplewood's takeover of LTCB. In 1999, total FDI into Japan hit about $14 billion—almost triple the 1997 level and about half the level of Japan's outward FDI. Thus, when Robert Fauver, senior adviser to the U.S. Department of State's under secretary of economic affairs, talks with Tokyo about finding and removing remaining impediments to FDI, he is tapping into the power of an idea whose time is finally coming.

Action is most effective when U.S. goals coincide with major Japanese interest groups.

U.S. political capital is limited. Hence picking and choosing battles is critical. Several conditions seem essential for success.

First of all, the most powerful leverage will occur where sectoral issues involving specific U.S. firms intersect with structural issues affecting the operation of the Japanese economic system. Without the urging of powerful U.S. constituents, mainly multinationals, Washington is unlikely to act. The most successful cases of sectoral-structural intersection have involved the role played by Toys "R" Us in reforming Japan's restrictions on the opening of large stores, the U.S. financial community in a series of financial agreements, and U.S. telecommunications firms in the current fracas over Internet access fees.

Second, action is most effective when the goals that the United States seeks for its own reasons coincide with the desires of major interest groups inside Japan. If only U.S interests are at stake with no corresponding interest group pressure in Japan, even the most ardent efforts often fail. The never-ending dispute over flat glass is a case in point. Leonard Schoppa's book, *Bargaining With Japan*, documents the criticality of "seeking allies."[18]

In many cases, Japanese business users of goods and services desire reforms that cut their costs. Consider the Internet access fee. Washington says past agreements by Japan to adopt "cost-based pricing" require that NTT—which has a nearly 100-percent monopoly in local phone service—lower its access fees by 40 percent in four years. NTT and the Ministry of Posts and Telecommunications are resisting, saying they will drop it only 22 percent. Because of NTT's high local call rates and high access fees, someone wanting to use the Internet often has to pay as much as $100 a month. Many Japanese business leaders have criticized NTT, including some potential Internet competitors like Sony and Toyota. Economic Planning Agency chief Taichi Sakaiya has publicly criticized NTT's stance for hindering wide-

spread adoption of the Internet. Indeed, some Japanese and foreign firms have allied to outflank NTT by using technologies other than local phones to provide Internet access. Deputy U.S. Trade Representative Richard Fisher's negotiating tactics have been very sensitive to the need for Japanese allies. At present though, it's hard to point to another case where Washington is making a high-profile issue with the same approach.[19]

Third, the most effective strategy is likely to be one that sets market forces into motion and lets those forces do the heavy lifting. Government's powers are limited, yet at times indispensable. Relatively small actions by government can loosen regulations and/or practices that suppress market forces. Once those restraints are removed, then the market can unleash great changes. For example, when NTT was the only game in town in long-distance service, Japanese customers had to pay as much as 350 yen (about $3.50) for a three-minute call within Japan. As deregulation gradually introduced new competitors—including foreign competitors—over the last decade, the price dropped by 80 percent. Rates in Japan remain four times higher than in the United States, but more progress can be expected. Competition has induced similar drops in international phone rates. If NTT's local phone monopoly ended, similar results would ensue.[20]

Finally, reforms in the right areas can trigger systemic ripple effects throughout the economy. The more sectors that face competition, the harder it is to maintain moats elsewhere. The ripple effects are likely to be larger in some sectors, particularly critical are finance, retail, and telecommunications. Finance and retail are the two ends of the daisy chain of cartels that hobble Japanese growth. To the extent that these two are opened up to competition, the links in between will tend to crumble. Finance dictates who gets to produce what. The more that capital is allocated on the basis of profitability rather than outdated *keiretsu* ties, the more that firms will have to reorient themselves toward greater efficiency. Retail is critical because price-fixing collusion cannot be sustained if high costs cannot be passed on to the final customer. Telecom is critical because the Internet revolution can cut through layer upon layer of middlemen while clearing out bloated back offices. Both of these are bulwarks of disguised unemployment and inefficiency.

Success Stories

Today, it seems that everyone in Japan walks around with a cell phone. It was not that way a few years back, when high prices suppressed demand. Motorola's pressure—via the U.S. government—to open the market created a revolution. Companies sold phones cheaply instead of leasing them

at high rates. Phone-call rates tumbled. In response, from 1994 to 1997, the number of cell phone subscribers increased from 500,000 to 24 million. In fact, according to Takashi Kiuchi, former chief economist at the LTCB, the purchase and use of cell phones increased GDP by about ¥1 trillion, or 0.2 percent of GDP, during that period. For an economy struggling to achieve 1 percent growth, this is substantial. Ironically, Motorola's own Japanese competitors—the very ones who had obstructed reform—were among the biggest beneficiaries.[21]

Obstacles to growth are woven into the very fabric of Japan's political economy.

There are two big lessons here. First, whenever competition is heightened, the fall in monopolistic prices is swift and sharp. Because lower prices raise consumer purchasing power, structural reform can enhance macroeconomic demand.[22] Second, even when change would benefit Japanese players, achieving it often requires the participation of foreign outsiders who can provide the countervailing institutions lacking within Japan.

Sometimes, Japanese ministries have invited some foreign entry, hoping it will make Japanese players more "lean and mean." The Ministry of Transport encouraged the alliance of United Airlines with All Nippon Airways as a way of taking Japan Air Lines down a peg. Similar thinking in the Ministry of Finance helped increase the presence of foreign asset managers like Fidelity. Often, the ministries hope—and foreign skeptics expect—that the foreign presence will be big enough to stimulate domestic players but not so big as to supplant them. The contrary will more often prove true, however: once Pandora's box is opened sufficiently, it will be hard to control the outcome.

Consider the chain reaction triggered by reforms in Japan's Large-Scale Retail Store Law (*Daiten-ho*), a product of the U.S.-Japan Structural Impediments talks. Prior to *Daiten-ho* reform, small retailers could legally block the opening of larger stores—domestic or foreign—to prevent "excess competition." Toys "R" Us was unable to open a single store. Since reform, Toys "R" Us has become Japan's largest toy retailer. Similarly, Tower Records, The Gap, and others now dot the landscape.

Reform of *Daiten-*ho is helping to break down the traditional pattern of exclusive relationships between dominant manufacturers and subordinate wholesalers and retailers. Lewis Cohen, a former U.S. trade official now serving as a consultant to Toys "R" Us, pointed to the findings of a 1994 study by the Japan Fair Trade Commission. It reported that before Toys "R" Us arrived, almost 80 percent of toy retailers sold them at or above manu-

facturers suggested list prices. By 1994, it was down to 30 percent. As result, according to industry sources, toy prices fell an estimated 20 percent.[23]

In this, as in other sectors, the activities of foreign firms formed the tip of a much larger Japanese iceberg. During the 1990s, discounters like Daiei, Jusco, and Ito-Yokado used *Daiten-ho* reform to launch extensive investments in large retail operations. The result was a major shakeup in Japan's incredibly inefficient distribution system, including the emergence of widespread discounting. From 1991 to 1997, sales at traditional department stores fell 12 percent while sales at "superstores" increased 25 percent. Whole layers of middlemen have been removed from the system. During those years, wholesale sales fell 16 percent despite a 4-percent hike in retail sales.[24]

> The very things that hobble growth also function as pillars of Japan's political system.

Daiten-ho reform illustrates how the United States can help tip the balance in an internal Japanese fight. By the late 1980s, domestic pressures from larger retailers were building on the Japanese government to lift restrictions. MITI, as usual, was divided. The Distribution Industry Division of MITI's Industrial Policy Bureau, allied to the large retailers, advocated modernization. MITI even produced a "Vision for the Distribution Industry in the 1990s," which some U.S. experts say would have produced significant reforms. But the Small and Medium Enterprise Agency, a defender within MITI of the mom-and-pop retailers, succeeded in blocking the reforms. The MITI minister at the time, Kabun Muto, was a mom-and-pop representative in the LDP. Today, by no coincidence, Muto is the head of the LDP's antireform caucus in the Diet. In the end, it took a de facto U.S.-Japan alliance—a U.S. initiative that was given *sotto voce* support both from Japanese discounters and from part of MITI, plus open editorial support from *Asahi* and *Nihon Keizai Shimbun*—to overcome firmly entrenched resistance.[25]

Finance is the sector where Japan has seen the most reform so far, including the "Big Bang." The Big Bang was an initiative announced in 1996 that loosened a wide variety of regulatory restrictions affecting such issues as product innovation, international capital flows, price competition in stock brokering, and entry into the banking and securities business. Foreigners certainly did not create the Big Bang. A series of U.S.-Japan financial services agreements were key links in the years-long chain of events leading to it, though. That's the conclusion of Robin Radin, who was managing director and general counsel of CS First Boston in Tokyo during the time of the negotiations and who authored a "strategy book" used by Treasury officials.

Radin, now a professor at Harvard Law School, makes the case that each increase in the presence of market forces made further market openings harder to resist. Back in 1984, the yen-dollar agreement between the United States and Japan reduced Japan's financial insulation from global markets, freed corporations from their dependence on Japanese banks by making it easier to raise funds outside of Japan, and began the process of deregulating interest rates. Then the financial scandals of the early 1990s destroyed the credibility of the traditional regime and of the finance ministry itself. By the mid-1990s, argues Radin, the ministry had no choice but to respond in some way to the fact that the combined effect of these trends had rendered the traditional financial regime unsustainable. At the same time, reforms introduced in the little-noticed Administrative Procedure Act of 1993 provided the potential to curb the ministry's traditional arbitrary use of "administrative guidance" to protect financial cartels. Taking advantage of these developments, a 1995 U.S.-Japan Financial Services Agreement "pushed the envelope" by introducing major changes in such areas as cross-border flows, introduction of new products, and asset management. Indeed, says Radin, it "established the policy platform for Big Bang itself."[26]

The United States can aid Japanese reformers, but it cannot substitute for them.

The key to success was that major Japanese interests needed financial reform for their own sake. In just one example, U.S. arguments in the insurance negotiations were supported de facto by Japan's corporate pension funds. These funds could no longer meet their obligations due to the low returns they were getting from Japan's life insurers. Within only a few months of the regulatory freedoms spawned by mid-1990s agreements, Japanese pension fund managers in firms like Honda and Sony as well as *Nenpuku*, the national employee insurance system, took tens of billions of dollars away from Japan's life insurance firms and put it into the hands of investment management firms, including foreign ones. Today, foreign firms play a major role as asset managers, stockbrokers, and investment bankers. Starting from negligible levels in the mid-1990s, Goldman Sachs is now Japan's fifth largest manager of retail and pension assets, with almost $20 billion under management as of mid-1999. Foreign stockbrokers handle up to one third of all trades on the Tokyo Stock Exchange.

The presence of foreign firms and investors has been critical in turning what could have remained mere formal changes in regulations into genuine changes on the ground. It is the foreigners' ability to seize market share by

offering higher returns that compels Japanese financial firms to follow suit. That, in turn, obliges Japan's corporations to become more efficient and profitable. For example, the new financial environment heightens pressure on firms to maintain share prices. Moreover, with foreigners now owning a record 18 percent of all Japanese shares, up from 5 percent in 1990, foreign trade has largely determined stock prices in recent years. Hence, when stock prices fall because foreign investors are impatient with delays in corporate restructuring, Japan's corporate elite now has to pay heed.[27]

Without the presence of foreign firms, the Big Bang would have a lot less bang. But without increased receptivity by Japanese companies and investors, foreign financial firms would have neither much presence nor much impact.

Cynicism Is Not Realistic

When asked about the approach recommended here, some U.S. officials have objected that "seeking allies" has long been a standard arrow in the U.S. quiver. It is true that this posture has been tried from time to time, particularly during the Structural Impediments Initiative of the early 1990s. It has not been raised to the level of a consistent strategic vision, though. Washington's right hand therefore knows not what its left hand is doing. In telecom, Washington allies with Japanese reformers, but on monetary issues the treasury supports the retrograde finance ministry against the Bank of Japan.

Another objection is that seeking allies has been tried in the past and failed to elicit much Japanese support. But past performance is not always a guide to future behavior. Admittedly, it's hard to seek allies when there are few allies around. But the economic crisis engenders new potential allies everyday. Proposals that failed 10 years ago when Japan felt on top of the world now receive a much different reception. Considering the substantial changes (by Japanese standards) that have already taken place (e.g., growth in FDI), cynicism is neither warranted by the evidence nor a practical guide to policymakers. Indeed, one former U.S. trade official contends that if Washington had maintained the cooperation with Japanese reformers that began in the Structural Impediments talks, "Japanese deregulation and economic reform would be much further along than it is today."

To be sure, U.S. action must be guided by a realistic sense of what is and is not possible. Otherwise, the dashing of false hopes will lead to bitterness. U.S. influence is limited. The United States can aid Japanese reformers, but it cannot substitute for them.

Still, to the degree that the United States takes effective action, it can be

of great help. Japan will most likely reform because the alternative is so debilitating. Certainly, there is no guarantee. Even under the best of circumstances, that process is going to take 5–10 years and will be a bumpy ride. A U.S. alliance with Japanese reformers, however, can both increase the odds of success and somewhat quicken the pace. Given the stakes, it is certainly worth the try.

Notes

1. Lawrence Summers, "The Ishihara-Morita Brouhaha," *International Economy* (November-December, 1989): 52. Despite the sentiments in this 1989 article, during the first Clinton term (1993-96), Summers was a force for moderation regarding trade policy toward Japan.
2. Japanese withdrawal continued through at least 1999 when loans fell by 24 percent, compared to a mild 3-percent withdrawal by other banks. See Bank for International Settlements, *Consolidated International Banking Statistics*, assorted issues, available at <http://www.bis.org/publ/index.htm>.
3. Peter Katzenstein and Takashi Shiraishi, *Network Power* (Ithaca, N.Y.: Cornell University Press, 1997), 77.
4. Stokes made this argument during a panel discussion with the author. Stokes has authored his own proposals for U.S. policy toward Japan. See *A New Beginning: Recasting the U.S.-Japan Economic Relationship* (Washington, D.C.: Council on Foreign Relations, 2000).
5. Bowman Cutter, interview with author, 1994.
6. Conversation with author, 1998.
7. For an analysis of the structural impediments to Japanese growth, see Richard Katz, *Japan: The System That Soured—The Rise and Fall of the Japanese Economic Miracle* (Armonk, N.Y.: M.E. Sharpe, 1998), ch. 2, 3, 4, 7, 8.
8. In its *Economic Outlook* report, the Organization for Economic Cooperation Development (OECD) puts Japan's long-term potential growth under current conditions at 1.25 percent. OECD, *Economic Outlook* (May 2000), 95.
9. For more on the demand-side obstacles and some reform proposals, see Richard Katz, "Economic Anorexia: Japan's Real Demand Problem," *Challenge* 42, no. 2 (March-April 1999).
10. Douglas Ostrom, "Tokyo's Changing Role In Financial Markets: Taking A Step Backward?" *JEI Report*, no. 43A (November 19, 1999): 8-9.
11. Conversation with author, 1995.
12. The Bank of Japan official's comment came in a private briefing in early 1999. For more on Clinton's support of Obuchi against the reformers, see Richard Katz, "Japan's Slow Road to Reform," *Christian Science Monitor*, September 29, 1998.
13. For more on the Ministry of Finance–Bank of Japan fight, see Richard Katz, "Reform at Stake in Fight over Money Supply," *Asahi Evening News*, October 19, 1999. For an economic analysis of why printing more money won't restore growth, see "BOJ-LDP Standoff Continues" and "Inflation Targeting Won't Restore Growth," *Oriental Economist Report*, (November 1999): 1-3.
14. Jeffrey Sachs and Andrew Warner, *Economic Reform and the Process of Global Integra-*

tion, no. 2002 (Cambridge, Mass.: National Bureau of Economic Research, 1994): 2.

15. See Everett Erhlich's "Preface" in Sumiye Okubo, *Prospects for Growth in Japan in the 21st Century* (Washington, D.C.: U.S. Department of Commerce, 1996).
16. Economic Planning Agency, *Economic Survey of Japan: 1995-96*. (Tokyo: EPA, 1996). For MITI's views, see *Asahi Evening News*, May 16, 2000, and Ministry of International Trade and Industry. *White Paper on International Trade, 2000*, Chapter 3.
17. Conversation with author, 1999.
18. Leonard Schoppa, *Bargaining with Japan: What American Pressure Can and Cannot Do* (New York: Columbia University Press, 1997).
19. See *Oriental Economist Report*, May 2000, 6 (interview with Richard Fisher).
20. "Regulatory Reform in the Telecommunications Industry" in *Regulatory Reform in Japan* (Paris: OECD, April 1999).
21. Takashi Kiuchi, conversation with author, 1997.
22. Although there is much concern with Japan's price deflation these days, there is a world of difference between falling prices caused by weak demand and price cuts forced by more competition. The former reflects weak demand; the latter will induce more demand. In terms of the common supply-demand curves of economics, the former reflects a falling demand curve, whereas the latter reflects a falling supply curve.
23. Cohen reports that the presence of foreign retailers in Japan gave them significant access to—and credibility with—MITI officials as they replaced the old *Daiten-ho* with a new *Daiten Ricchi-ho* (Large-Scale Retail Store Location Law). Whereas the former was administered by MITI, the latter will be administered by localities. Under the new law, stores must abide by ordinary zoning-type regulations (parking space, traffic congestion, noise, sanitation, etc.), but they can no longer be obstructed simply because they cause "excess competition." Foreign input had an important role in shaping the national guidelines, and, although some foreign retailers fear that local "mother hens" will obstruct new store openings, these guidelines limit their ability to do so.
24. A study by the Bank of Japan found that, in a number of industries where globalization and deregulation has increased competition, price mark-ups have fallen. See Richard Katz, "Unsustainable: Japan's Dual Economy Continues to Fray," *Oriental Economist Report* (May 2000): 8
25. For a discussion of this split within MITI, see Schoppa, *Bargaining with Japan*, ch. 6. The split continues to this day.
26. See Robin Radin's May 2, 1996, Harvard lecture, "The Regulation and Deregulation of Japan's Financial System," and a March 10, 2000, lecture, "Japan's Big Bang: Historical Context and Future Prospects " The "strategy book" was *Negotiating Principles for Opening Japan's Financial Markets* (Tokyo: CS First Boston, 1994).
27. For foreign ownership share of Japanese stocks, see Ken Okamura, "Japanese Equity Weekly" (Tokyo: Dresdner Kleinwort Benson, June 19, 2000).