JAPAN: REFORM AND RECOVERY

Joichi Ito

I would like to briefly talk about what I think is going to happen in Japan, where we are today, and what I think we need to do afterwards. I think there are three big problems in Japan: the lack of a market, the aging population, and the bad debt issue. I would like to present a disclaimer: I am neither an historian nor an economist, and all my comments are based upon a decade of entrepreneurial business building in Japan. So, I will have to make up in honesty what I lack in knowledge.

The bad debt issue is an issue that a lot of very smart people have talked a lot about. Since the bad debt looks like 1/12th of the financial savings of Japan, it's a procedural issue and not something I am going to dwell on today. I do believe that the fact that we have a savings cushion is actually a problem rather than a benefit. Because we think we have a lot of money, we don't have the sense of urgency for reform that countries like Korea have. Yet, after World War II or after the Meiji revolution, Japan showed that it is very strong during crisis situations, and that it has the resilience to rebound after a hard landing. A hard landing or a crash will prove to be much better for Japan than some sort of soft landing with a false bottom.

Regarding the aging population, in 1950 after the war, the ratio of workers to retirees was 12.2 to 1; in 1995, it's 4.8 working people versus 1 one retiree. According to a 1998 U.N. population projection, assuming zero immigration, in 2025 the ratio will be 2.2 to 1 and in 2050 it will be 1.7 to 1. Many countries are facing this problem, but Japan is going to face it first. This is one reason why we need to do things quickly before our aging population becomes an issue and makes it difficult for us to rebound.

One of the biggest problems in Japan is that we have been unable to shift our human and financial resources into industries in which Japan can be globally competitive. We have not adapted to the global markets and Japan is still sending its brightest people to industries that are no longer competitive. Considering the emergence of China and the rest of Asia in manufacturing, the fact that Japanese information technology services and biotechnology are not globally competitive is a problem, and those are the areas in which we should be investing people and money. What is important is to change the current structures that cause finance and people to be sent to the older, legacy industries. We should all agree that the "Japan Inc." method of bureaucrats trying to plan things hasn't worked in the past. The industries that are most globally competitive, like the automobile industry or the electronic industry, are the industries where there was very little government meddling. The financial services industry was quite tightly controlled and is now having competitive problems. So, the core point is to create a market mechanism and to allow the market to decide where resources should go.

The fact that we don't have a functioning market is one of the biggest problems in Japan. There are a lot of statistics that show that the market isn't functioning. People say that Japanese have all of their money in savings, but I think the Japanese people are smart. The Japanese stock market is rigged against individuals. It's basically a market that caters to insiders and large corporations that have used the stock market to trade with each other. If you look at some of the indices, their returns on funds are very low. If you look at foreign investment in Japan, it is $97.00 per capita. If you look at the U.S., it's $1,034 per capita. Korea is twice as high as Japan at $199.00 and Singapore is $1,793.00 per capita. Obviously, foreign investors don't trust our market. But what's even more glaring is the fact that the amount of money invested by individuals in the stock market in Japan is less than the amount that foreign investors are investing in Japan. Basically, the Japanese people distrust the stock market, and for a good reason, because it does not produce returns.
One of the most important problems with Japan is that the risk return mechanism, which is the core of a good market, is not functioning. After the war, in order to get efficiencies in manufacturing, there was a great deal of collusion between the government and business. The educational system filtered the obedient, intelligent elite into these large corporations that had very low risk and high returns. The lower elites ended up going into subsidiaries - smaller companies - and new businesses that had high risk and low return. This two-tiered system of low-risk/high return and high-risk/low return and the market and employment system that reflected it was not a market mechanism that people could trust. This is now changing, but in the year 2000 only 2% of the Japanese population was engaged in start-ups, whereas in the U.S. 13% of people are engaged in start-ups. In Japan there is a social stigma against starting new businesses, because it is quite stupid to start a new business if it is a high risk/low return venture.

At the risk of sounding like an anarchist, I think that one of the most important things for Japan is to first create a risk return mechanism that works, get the people to believe in it, and it will then free up the savings to go into markets and to launch start-up companies instead of entering these large legacy companies that are not globally competitive. Proof can be found in the Nissan and Long-Term Credit Bank of Japan cases. Carlos Ghosn came in at Nissan and turned it around. Before he did that, the employees and the former CEO knew exactly what needed to be done, but they couldn't default on the social contracts that were in place. Carlos Ghosn came and made the obvious choice, which was to build an efficient business in a productive market. Tim Collins and Ripplewood bought the Long-Term Credit Bank of Japan and turned it around into Shinsei Bank. They banned the use of the word kashikari, which means indebtedness, and turned the bank into an efficient bank that is quite profitable. So, foreigners entering Japan are proving that you can actually run businesses and make them profitable without having them woven into the fabric of Japanese relationships. That is a myth that we can dispel with help from the outside. The companies that are competitive will survive, but we need to get rid of the companies that are not competitive and we need to reset some of the human relationship structures and some of the power structures that are still in place.

I am predicting there inevitably will be quite a great deal of anarchy: a lot of the large companies will fail, there will be a financial collapse, we will have instability in the political system, and crime will increase. What is important, though, is that we go to the real bottom. We'll hear a click when we get to the bottom. If we don't make it all the way to the bottom, and if we hit the false bottom and try to turn back up again, it won't work because people like me will know that it is not the real bottom. We won't take risks, because what a false bottom involves is continued corruption and inefficiencies that we really need to get through.

My key point is that there are lots of people like me who are waiting for Japan to hit bottom and we're ready to take risks and jump in then. Also, we're not going to fall through the bottom. I don't want people to be afraid to trust the market and allow Japan to hit the bottom. We need to do it quickly, because if we don't do it quickly, I think there is an aging issue. Emigration now exceeds immigration in Japan, and the average age of people leaving is 35, so there is an accelerator on the aging population. Many people my age are not going to hang around for a long time if we don't see reform.

Actually, my peers and I call Prime Minister Koizumi "Koizumi the destroyer." We're much more interested in seeing Koizumi work on destroying a lot of things rather than on building. "Scrap and build" has become a popular word in Japan, but as a nation we don't like talking about the scrap part. Everybody in Japan offers to work on the build side. So, we want Koizumi to singularly focus on the scrap side first and get to the very bottom. Thus, I am not concerned that he doesn't have a plan. I don't think we want a plan because I have never seen a Japanese plan work the way that we were told that was going to work. What is critical is that we must get to the bottom of all this very quickly and unleash the entrepreneurial spirit, just as happened after the war in Japan.
Today represents a great opportunity to eliminate the old inefficiencies, because after the war the Americans put the old power structure back in place for fear of communism. I think this could be the first time since the Meiji Revolution, if we are lucky, that we can reverse some of these things and make Japan a truly open and free market. That's the goal and a lot of things have to change. The role of women will help the aging population issue. We will need financial literacy in Japan. Self-esteem will also be very important because as traditional brands collapse, people will have problems with whom to trust, and the most important thing is to trust oneself.

One of the problems I see is that after Enron, there has been a back peddling in Japan with many saying that the Americans can't do it, so we should stick to our old ways. I say we have to go beyond that and be tougher. That is why foreign investors and CEO's are among the most crucial elements in the Japanese reform process right now. The fact that Nissan and Ripplewood work shows that there are great possibilities for Japanese businesses. We have a stick-to-it-ness and a hard-working labor force. A flexible ideology can also help change, but we must first prove we can run a free market with best practices. We can "Japanify" it afterwards. The Enron issue remains a problem, so all the support we can get to push Japan into this free market with American best practices will be the key to reform.

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Yoshimasa Hayashi

We need market changes, and my topic is how to do so on the political and policy side. I will discuss the steps necessary at the macroeconomic level, the microeconomic level, and the influence of the media and politics on reform.

In terms of microeconomic policy, our biggest agenda is the non-performing loan (NPL) disposal issue. In the past 8 years, we disposed of 70 trillion yen worth - or half - of the NPL attributable to the burst of the bubble economy. What remains is a mixture of the remaining debt from the bubble burst combined with the results of the bad economic times that followed. The results of a special inspection of financial institutions – although there are doubts about this inspection in the market and the media – will be released this April. I believe that rather than beginning with public money injections, it is necessary for banks to try on their own to seek capital from the market. Thus, we will learn how the market views each of the financial institutions. In addition, we must detach NPL from the banks and either revitalize companies with NPL or dispose of that NPL. These two approaches are not the same, nor will they happen at the same time. If we can utilize our RCC as a fund as we are planning, we can save the banks and regain the financial matchmaking ability of the banks. We can then try to revive all those companies that - although they have NPL - have a chance of survival. We cannot save all the companies who have NPL, but we need to take some time to determine which companies have the chance to survive. These judgments should not be made by the FSA, but rather by the private sector.

On the macroeconomic side, we first need to face the issue of monetary policy. I am leaning towards a price level target or an inflation target. The Bank of Japan now uses the Consumer Price Index (CPI) as a target figure, but they admit that a CPI target has an upper side bias because it is static. With an upper side bias, price stability is not at zero, but rather a positive figure. We need a price level target or inflation target to correct for the upper bias of CPI. We have to be very careful how we talk about this because a fully independent Bank of Japan, not us, should decide how to achieve this goal. In addition, communication with the market will be very important, because there is debate within the Bank of Japan showing miscommunication with the market.
A second important macroeconomic policy is tax reform. Because we have a very big fiscal deficit, we cannot use expenditures effectively. Thus, tax reform this year will be an important fiscal side policy. The three principals of the tax reform should be fairness, simplicity, and neutrality. However, for the Ministry of Finance, neutrality means revenue-neutral. I propose that rather than achieving static revenue-neutrality for each fiscal year, we should consider dynamic revenue-neutrality over perhaps 5-10 years. Such a tax reduction would change to positive tax revenue in the future, so that in 5-10 years it would be revenue-neutral. The tax bureau has not yet accepted this particular idea, because there is no guarantee that it will become revenue-neutral over time, but we may be at a point where we should try this approach despite the risks. On the tax reform side, the minimum taxable income should also be lowered, as it is presently very high. The opposition parties, including the Communist Party, say that because of the high Yen valuation, the minimum taxable income is not high, but it is in fact about 3.6 million yen for the average household. This is the highest among G7 and OECD countries, so I believe it should be lowered to make it possible for more people to share the burden. Finally, on the structural reform side of tax reform, this year we should approve the tax ID number issue. This is a technical issue, but the passage of many structural reforms will be simplified with the creation of tax ID numbers.

For macroeconomic change in the short- to middle-term range, we are aiming at approximately 1-3 years, but structural reform on the microeconomic side will take about 10 years. Critics say that the 1990s were the lost decade for Japan, but the first 5-6 years of 90s were spent creating a new political election system, i.e. single member district and other campaign finance reforms. Real structural reforms on the social and economic sides started as late as 1997 after Hashimoto came into power and the financial "big bang" was implemented on April 1, 1997. This resulted in JASDAQ, which is still very imperfect, but has at least been launched. We also passed the FILP (Fiscal Investment Loan Program) reform two years ago, and imported the 401K and IRA systems to Japan, although we still do not have a Roth IRA because of the lack of a tax ID number. In addition, we enacted the Technology Transfer Act and the Bayh-Dole Act, as well as other smaller structural reforms, such as the limited term tenant law, the lease law on the housing side, and the start of the Japanese FASB (Financial Accounting Standard Board).

Administrative reform was begun last year, as we restructured the ministries to the present 12 ministries. These reforms show we are trying to shift the Japanese system from a developing country model to a developed, mature economy model in which there is a shift to a freer career development system from the lifetime employment system. Individuals can now choose a career path and the government should be neutral towards each career development opportunity. A second administrative reform is the shift from administrative control to judicial control, such as in the Product Liability Law. The third is the reform from indirect financing of bank loans to direct financing, such as equity finance.

It is worth noting that these structural reforms will take a decade to truly be implemented. For example, we created a 401K system, but not many people are currently using it because they have yet to become accustomed to the new system. However, as individuals use it more year by year, we will eventually reach a critical threshold and that structural reform will truly take hold. Thus, while on the policy side we are creating all this new legislation, we must encourage people to utilize these systems and show their success so that younger people will follow.

Lastly, it is important to take note of media and political issues, because "telepolitics" is the key word on the Japanese political scene now. Newspaper journalists are now complaining that TV shows are destroying journalism. For example, when you see Japanese TV shows on politics, they make use of background music (BGM) and lighting to give the viewer a positive or negative image of politicians. Such visual and audio techniques to influence the viewer cannot be used by the paper media, and such techniques have been very effective in influencing the polls.
At first, many politicians ignored this phenomenon, but we can no longer ignore telepolitics, as recent political scandals have recently resulted in politicians being expelled from the Parliament. However, telepolitics is not necessarily a negative phenomenon. It can be compared to professional wrestling. Before Koizumi, politics was like amateur wrestling, which is athletically pure but not viewed by the public. Koizumi ushered in an age of politics like professional wrestling, as people now find politics more exciting and interesting to watch. Simply rejecting the sensationalism of politics is a natural reaction, but this media attention has made ordinary people more interested in politics and the policymaking process.

Another media concern is with the Japanese newspapers, which - except the Mainichi paper - do not use bylines and tend to write articles using the passive voice. What's more, what is reported is sometimes completely incorrect. Another problem with newspaper media is that exclusive press clubs exist for each ministry and each government office, so that the relationships between reporters and those governmental institutions have occasionally become inappropriate.

We have to clear up all such media problems, because the media - and especially televised news shows - have become a great influence on the polls. Moreover, polls themselves are a problem because the media does all polling; we don't have independent polling institutions, such as Gallup. This can be problematic because a TV director has the power to use BGM and lighting to disseminate a bad image about one politician, immediately take a poll after that show, and report the negative poll results soon after. People then see these polls and start to believe the negative image. Therefore, we need some fair rules so that journalists and media actually provide better policy understanding and fairer policy discussions.

Thus far, Koizumi has done a better job of media relations than his predecessors, except Prime Minister Miyazawa. However, when he dismissed his former Foreign Minister, his approval rate went down from 80% to 40%. I advised him that those 40% who dropped support are TV show supporters, and the remaining 40% are those people who really understand the issues and are trying to be hopeful for the coming structural reform. I am still hopeful that with this support base that he will carry out those structural reforms discussed above. The hidden fact is that we changed the party presidential election rule this January at the LDP Convention so that he is guaranteed tenure of two years from September 2001. Thus, it is his option to call elections, but if he doesn't call elections, his tenure will be automatically almost two years from now. So, we should move ahead with structural reform in that period before it becomes too late. We will try our best, and I hope in 3-4 years that we will have accomplished the goals outlined here.

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