



Backgrounders

Executive Summary

No. 1530

March 26, 2002

ADDRESSING THE LOOMING FINANCIAL CRISIS IN JAPAN

BALBINA Y. HWANG AND BRETT D. SCHAEFER

As March 31 approaches, Japan faces critical decisions regarding the future of its economy. This deadline, which marks the end of the financial year, is crucial because Japanese banks must account for their assets and performance, which may fail to meet investors' expectations. The fear is that a loss of confidence in the banks will cause widespread distress in the financial system, which could affect the United States.

Bad news in the Japanese economy is not new. Japan has experienced stagnant growth and four recessions since 1990. Real estate prices have fallen to their 1982 value, and taxpayers have paid for approximately \$1 trillion in failed stimulus packages over the past decade. What makes the current recession more ominous than the previous three is that it marks the first time in modern Japanese history that asset and labor values have fallen simultaneously.

While the Bush Administration cannot spearhead the process to reverse this downturn, it can and should clearly communicate U.S. priorities to the Japanese government and people and provide unequivocal political support for efforts to enact reforms. The United States should also consider assembling key economic and financial advisers to

assist the Japanese leadership in implementing reforms; creating an inter-agency task force in the Administration, overseen by the National Security Council, to coordinate communication with Japan and underscore the critical security aspect of restoring vitality and confidence in the Japanese economy; and formulating a last-resort contingency plan to insulate the U.S. economy from a possible crisis in the Japanese financial system. The contingency plan should promote strong economic growth and trade with the rest of East Asia. It should also ensure that the U.S. banking system is not unduly exposed to Japanese banks and alert U.S. businesses and investors that they will not be bailed out in the event of a Japanese financial crisis.

The Japanese government has been in denial about its economic problems for more than a

Produced by the
Center for International Trade
and Economics (CITE)

Published by
The Heritage Foundation
214 Massachusetts Ave., NE
Washington, DC
20002-4999
(202) 546-4400
<http://www.heritage.org>



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decade. This denial has gradually escalated a difficult financial problem into one of enormous proportions, with potentially serious consequences for the global economy. The Bush Administration obviously cannot solve Japan's economic malaise. That task awaits action by the government of Japan under the leadership of Prime Minister Junichiro Koizumi.

Koizumi's government must end the dangerous spiral of deflation. The latest gross domestic product (GDP) figures for the fourth quarter of 2001 reveal that there was a 12 percent drop in private-sector investment. This, in effect, nullifies a 1.9 percent increase in private consumption and a 2 percent rise in household consumption for the same quarter. The leadership must act quickly to counter the prevailing mood of political paralysis.

The public's lack of faith in the Japanese leadership's commitment or ability to implement hard reforms has depressed consumer spending. In order to jump-start the economy, the leadership must therefore:

- **Terminate ineffective Keynesian infrastructure projects.** Japan spent \$1 trillion on 10 different stimulus packages in the 1990s with no lasting positive impact on economic growth. Worse, as a result, public debt has ballooned to 140 percent of GDP—over \$6 trillion, the highest level of any major developed economy.
- **Resolve the problem of non-performing debt.** Non-performing loans have become an increasing portion of overall bank assets, resulting in a decline in new loans that weakens the overall financial system and impedes recovery. Foreclosures are necessary to resolve these problems. The Resolution Collection Corporation was established in 1998 for this sole purpose. But the RCC has purchased and resold only \$139 billion in non-performing loans, an amount that is dwarfed by the private sector's \$1.768 trillion estimate of non-performing loans. The RCC should be encouraged to be more aggressive in disposing of bad debt.
- **End government subsidies and protection for private businesses.** The government should

end its support of the private sector, such as its implicit bailout of the debt-laden retailer Daiei. It should instead, through legislative changes, encourage corporate restructuring and more flexible deployment of workers. In 1999, the government injected banks with \$56 billion of taxpayers' money to prevent them from collapsing but did little to encourage distressed corporate borrowers to downsize efficiently. That failure contributed greatly to the impending crisis in the financial sector.

- **Embrace free-market competition.** Japan should increase domestic competition by allowing large and inefficient businesses to fail unless they are restructured into slimmer, potentially profitable operations. This may entail painful mass layoffs, which traditionally are anathema to the Japanese. Competition can be further increased by deregulating and breaking up the old cartel structure of the nation's banking system. The government already has made efforts to further this goal with plans to end government guarantees of bank assets, but this reform measure has been delayed several times due to political pressures. Prime Minister Koizumi must ensure that these plans are implemented without delay, for they are key to reforming the failing the banking system.
- **Reduce taxes.** Resuming economic growth requires increasing private consumption. The most efficient way to accomplish this is to increase the resources that are available for individuals to spend by lowering the tax burden.

Recovering from the economic problems resulting from 10 years of willful inaction is no simple task and will not be accomplished quickly. However, failure to undertake these tough reforms will consign Japan's economy to a steeper decline that will lead to an economic crisis that harms other economies, particularly in East Asia, and undercuts a global economy that is just now recovering.

—Balbina Y. Hwang is Policy Analyst for Northeast Asia in the Asian Studies Center, and Brett D. Schaefer is Jay Kingham Fellow in International Regulatory Affairs in the Center for International Trade and Economics, at The Heritage Foundation.

ADDRESSING THE LOOMING FINANCIAL CRISIS IN JAPAN

BALBINA Y. HWANG AND BRETT D. SCHAEFER¹

As March 31 approaches, Japan faces critical decisions regarding the future of its economy. This deadline, which marks the end of the financial year, is crucial because Japanese banks must account for their assets and performance, which may fail to meet investors' expectations. The fear is that a loss of confidence in the banks will cause widespread distress in the financial system, which would also affect the United States.

Bad news in the Japanese economy is not new. Japan has experienced stagnant growth and four recessions since 1990. Real estate prices have fallen to their 1982 value, and taxpayers have paid for approximately \$1 trillion in failed stimulus packages over the past decade. What makes the current recession more ominous than the previous three is that it marks the first time in modern Japanese history that asset and labor values have fallen simultaneously.

While the Bush Administration cannot spearhead the process to reverse this downturn, it can and should clearly communicate U.S. priorities to the Japanese government and people and provide unequivocal political support for efforts to enact

reforms. The United States should also consider assembling key economic and financial advisers to assist the Japanese leadership in implementing reforms; creating an inter-agency task force in the Administration, overseen by the National Security Council, to coordinate communication with Japan and underscore the critical security aspect of restoring vitality and confidence in the Japanese economy; and formulating a last-resort contingency plan to insulate the U.S. economy from a possible crisis in the Japanese financial system. The contingency plan should promote strong economic growth and trade with the rest of East Asia. It should also ensure that the U.S. banking system is not unduly exposed to Japanese banks and alert U.S. businesses and investors that

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1. The authors would like to thank Research Assistants Anthony Kim and Kimberly Thompson for their help in preparing this paper.

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The Japanese government has been in denial about its economic problems for more than a decade. This denial has gradually escalated a difficult financial problem into one of enormous proportions, with potentially serious consequences for the global economy. The Bush Administration obviously cannot solve Japan's economic malaise. That task awaits action by the government of Japan under the leadership of Prime Minister Junichiro Koizumi.

THE PATH FROM ECONOMIC SUCCESS TO DISASTER

A decade ago, many argued that Japan would overtake the United States as the world's pre-eminent economic power.² Some even speculated that Japan, not the Soviet Union, was America's most pressing security concern. For instance, prior to his tenure as Secretary of the Treasury, Lawrence Summers stated that "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."³

These warnings seem misplaced today as Japan struggles to escape from its decade of economic stagnation and recession. Despite recent poor performance, however, there is no denying Japan's remarkable success over the past 50 years. With economic growth that outpaced the average of Western economies, Japan became one of the world's wealthiest nations on a per-capita basis. Growth in real gross domestic product (GDP) averaged 5.1 percent between 1960 and 1999, including a remarkable average of more than 10 percent

during the 1960s. And Japan's GDP per capita increased fourfold from \$5,343 in 1975 to \$23,257 by 1998.⁴ This growth outpaced the OECD average on a purchasing power parity basis between 1975 and 1999.⁵ (See Chart 1.)

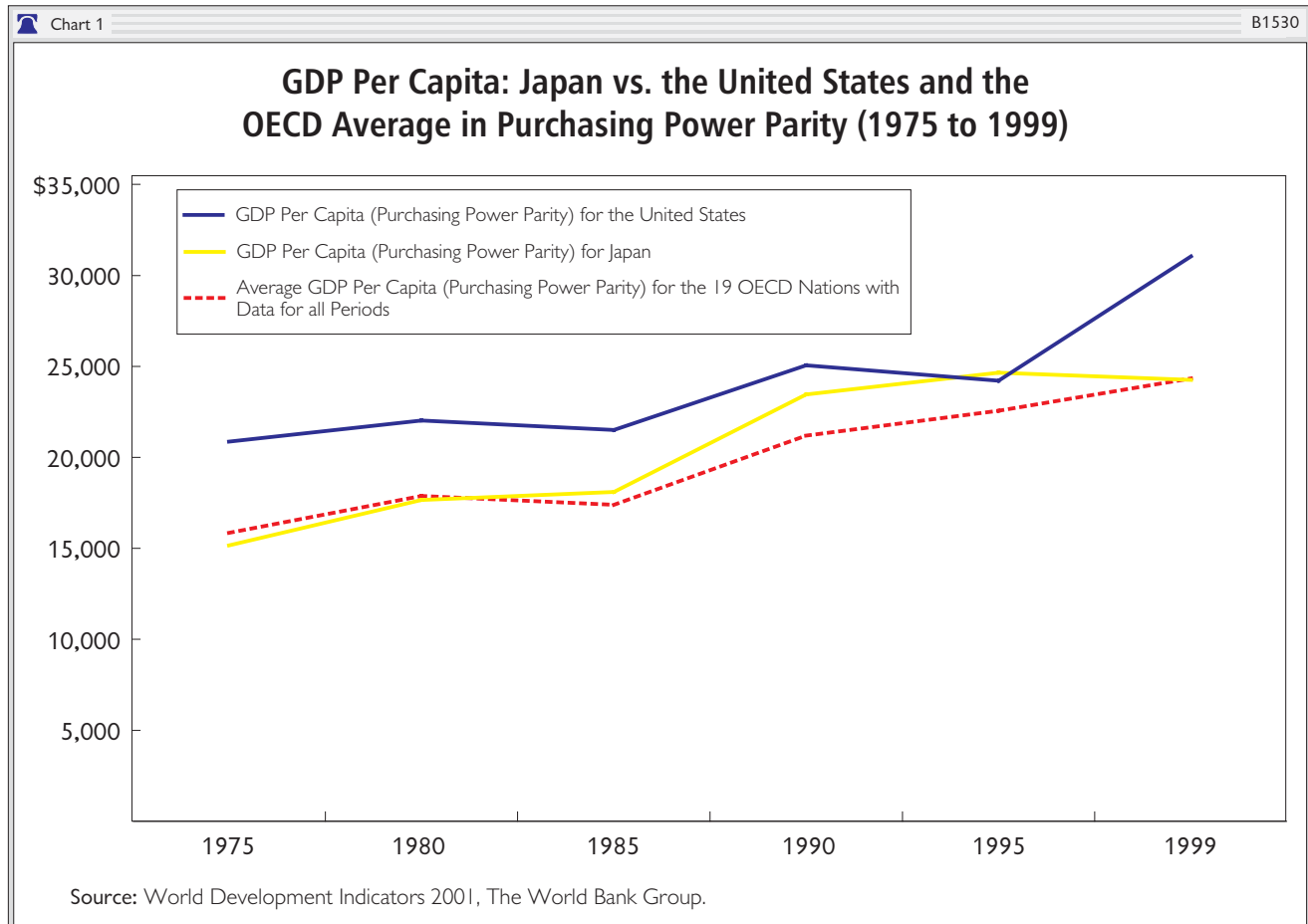
Japan's development from a war-torn economy to an economic superpower was based on its tradition of strong ties between the government and the private sector, which date back to the Meiji Restoration. This political and economic reform movement was launched in 1873 by a group of samurai who overthrew the ruling Tokugawa shogunate that had allowed Japan to ossify under a century of stagnation. The reformers were successful in invigorating Japan by entwining its traditional values of hard work, enterprise, and social cohesion with Western entrepreneurial institutions and practices. However, they also left a legacy of government-led industrial policy and market intervention, such as protectionism and managed trade.

While the Meiji Restoration set the stage for the industrialization of modern Japan, the process was completed in the post-World War II reconstruction period. The American occupation of Japan from 1945 to 1952, much like Admiral Perry's arrival in 1853, transformed Japan's society and economy. American reconstruction efforts focused on establishing a democratic government, decentralizing industry, devolving government authority, and broadening access to education. Although imposed by a foreign and victorious power, these changes corresponded with principles of the Meiji Restoration and, therefore, were more readily acceptable to the Japanese people than they might otherwise have been.⁶

The liberalized economy of post-war Japan, however, was not a free market. Japan's government

2. Prominent proponents of this argument include Ezra F. Vogel, *Japan As No. 1: Lessons for America* (Cambridge and London: Harvard University Press, 1979); Douglas Frantz and Catherine Collins, *Selling Out: How We Are Letting Japan Buy Our Land, Our Industries, Our Financial Institutions, and Our Future* (New York: Contemporary Books, 1989); and Clyde V. Prestowitz, Jr., *Trading Places: How We Allowed Japan to Take the Lead* (New York: Basic Books, 1988).
3. Richard Katz, *The System that Soured: The Rise and Fall of the Japanese Economic Miracle* (Armonk, N.Y.: M. E. Sharpe, 1998), p. 9.
4. World Bank *World Development Indicators 2001*.
5. *Ibid.*
6. See George C. Lodge and Ezra F. Vogel, *Ideology and National Competitiveness: An Analysis of Nine Countries* (Boston: Harvard Business School Press, 1987), pp. 144–155, and *Competing Economies: America, Europe, and the Pacific Rim*, Office of Technology Assessment, Congress of the United States, OTA-ITE-498 (Washington: U.S. Government Printing Office, 1991), p. 239.

NOTE: Nothing written here is to be construed as necessarily reflecting the views of The Heritage Foundation or as an attempt to aid or hinder the passage of any bill before Congress.



remained actively involved in its economy, providing vigorous protections and concentrating on manufactures for export.⁷ Foreign investment was closely regulated and even discouraged unless Japanese partners retained control. The government subsidized new industries and the modernization of old ones; purchased patents and licensing agreements for promising technologies; and supported students and professionals studying abroad—all in an effort to encourage rapid industrialization.

Government intervention in the economy also included directing capital and resources into favored sectors, subsidizing exports and restricting imports, and artificially suppressing the value of the

yen.⁸ Japan's financial system and interest rates were rigidly regulated and controlled by the government to support export-led economic growth.⁹ Additionally, government policies successfully encouraged high rates of household savings. Private markets played only a minor role in guiding those savings to the corporate sector.

Government activities were spearheaded through bureaucracies such as the Ministry of International Trade and Industry (MITI), the Federation of Economic Organizations (*Keidanren*), the Industrial Structure Council, and the Economic Planning Agency. These agencies maintained contacts with industry and other government bureaucracies to

7. Initially, these exports were textiles and low-grade electronics; but as wages increased, lowering the competitiveness of these products, the government subsidized investments in heavy industries like steel, machinery, ship building, and automobiles. See Lodge and Vogel, *Ideology and National Competitiveness*, p. 164.

8. See Michael E. Porter, *The Competitive Advantage of Nations* (New York: Free Press, 1990), p. 414.

9. Thomas F. Cargill, "Asia's Financial Crisis and Japan," Department of Economics, University of Nevada, Reno, December 15, 1997, at www.jiaponline.org/publications/carhdout.html (February 25, 2002).

coordinate efforts, including working with the Development Bank to provide subsidized financing for favored businesses or industrial sectors.¹⁰ Such a coordinated strategy helped launch many Japanese industries as world market leaders of exports in their sectors.¹¹ However, many private-sector industries, such as the auto, machine tool, and computer industries, defied government efforts to limit competition, and to the benefit of their businesses as well as the overall economy, their competitive efforts earned them great success in international markets.¹²

WEAKNESSES CAMOUFLAGED BY PAST SUCCESS

Following such a pattern of development, Japan was widely trumpeted as the ideal model for economic success in the 1970s and 1980s. Developed and developing countries alike, including even the United States, were urged to follow Japan's blend of industrial, trade, and financial policies of government-guided protectionism combined with an emphasis on capital markets, high personal savings, and an educated, disciplined workforce.¹³

But many of the policies credited for Japan's dramatic economic success in the 1970s and 1980s are now at the heart of its current malaise. The government's success in aiding certain industries, such as steel and auto manufacturing, is overshadowed by its failure to develop industrial dominance in other industries such as the chemical, plastics, aerospace, aircraft, and software industries.¹⁴ This suggests that government successes were achieved when policies simply boosted industries in which Japan had an existing comparative advantage but that government efforts to support industries that lacked comparative advantage were insufficient to counter market forces.

Micromanaging Domestic Production

Today, the government's continued intervention in support of declining industries only worsens structural inefficiencies in the economy. For example, in the construction, agriculture, or food industries, when domestic demand declines, the government intervenes by coordinating plans to reduce production rather than allowing market forces to prevail and force consolidation or closure of the least competitive elements of the industry.¹⁵ The lack of free-market competition is a serious weakness highlighted by Japan's current poor economic situation and is a major impediment to recovery.

Intervening in International Competition

Another example of inefficient government intervention is in the area of international trade. When a business sector can no longer compete internationally, the Japanese government increases barriers to foreign imports to reserve the domestic market for these noncompetitive industries and subsidizes foreign exports.¹⁶

While these practices are politically attractive in the short term in that they keep domestic businesses operating and unemployment low, they have significantly negative long-term consequences for the economy. As capital is displaced from healthy businesses to "zombie" corporations that would otherwise expire in a free market, competitive players are prevented from expanding their operations. This feature of the Japanese economy, as Michael E. Porter observes in *The Competitive Advantage of Nations*, creates a

study in contrasts. On one hand, [Japan] contains some of the most competitive firms and industries in the world. . . . On the other hand, however, there are large portions of the Japanese economy that not

10. See Lodge and Vogel, *Ideology and National Competitiveness*, pp. 164–166.

11. See Porter, *The Competitive Advantage of Nations*, pp. 384–386.

12. See *ibid.*, pp. 384–414.

13. *Competing Economies: America, Europe, and the Pacific Rim*, p. 239.

14. See Porter, *The Competitive Advantage of Nations*, p. 414.

15. See Lodge and Vogel, *Ideology and National Competitiveness*, p. 168, and Porter, *The Competitive Advantage of Nations*, p. 413.

16. Examples given are textiles, steel, and shipbuilding. See Lodge and Vogel, *Ideology and National Competitiveness*, pp. 168–169.

only fail to measure up to the standards of the best worldwide competitors but fall far behind them.¹⁷

The United States has also fallen victim to this practice, as demonstrated by President George W. Bush's recent decision to increase tariffs on steel products to protect domestic producers. However, unlike Japan, the United States does not do this widely or regularly. The sectors that were most sheltered by the Japanese government in the past decades are now the least successful. Regulation and control of the domestic health sector, for example, has retarded innovation and lowered productivity.

The inherent dichotomy of an economy that is characterized by a vigorously competitive export orientation and a focus on increasing innovation and productivity, as well as vastly inefficient protectionist business relics sheltered from foreign and domestic competition, prevents Japan from realizing an economic recovery. While the burden of these contradictory impulses could be borne during the years of economic expansion, it can no longer be tolerated during a period of prolonged stagnation.

A LOST DECADE

Japan must embark on a new economic path and depart from its "lost decade." In 1986, Japan began to experience rapid inflation in land prices and equity, and entered into what is commonly referred to as a "bubble economy." The bubble was created when the Bank of Japan pursued a policy of limiting the appreciation of the yen and simultaneously increasing liquidity and money supply. This excess liquidity was invested in assets, artificially driving up asset values.

The bubble burst when the Bank of Japan became concerned about the rapid escalation in asset prices and doubled the discount rate between May 1989 and August 1990, dramatically increasing interest rates and chilling new borrowing. The resulting collapse in asset prices led to Japan's most serious recession since World War II.¹⁸

This recession was the precursor to more than 10 years of stagnation and lackluster growth. (See Chart 2.) Japan has experienced a number of periods of real GDP contraction since 1990, and growth during this period averaged a dismal 0.37 percent. The recession of 1989–1990 hit the financial industry particularly hard by weakening balance sheets, and companies that were heavily invested in real estate took a strong hit.

Japan's response to the burst of the asset bubble was guided, as usual, by the powerful bureaucracy and was marked by denial, delay, and obfuscation. Asset prices fell below the borrowed values. In the United States, this would lead banks to call in loans or demand additional collateral.

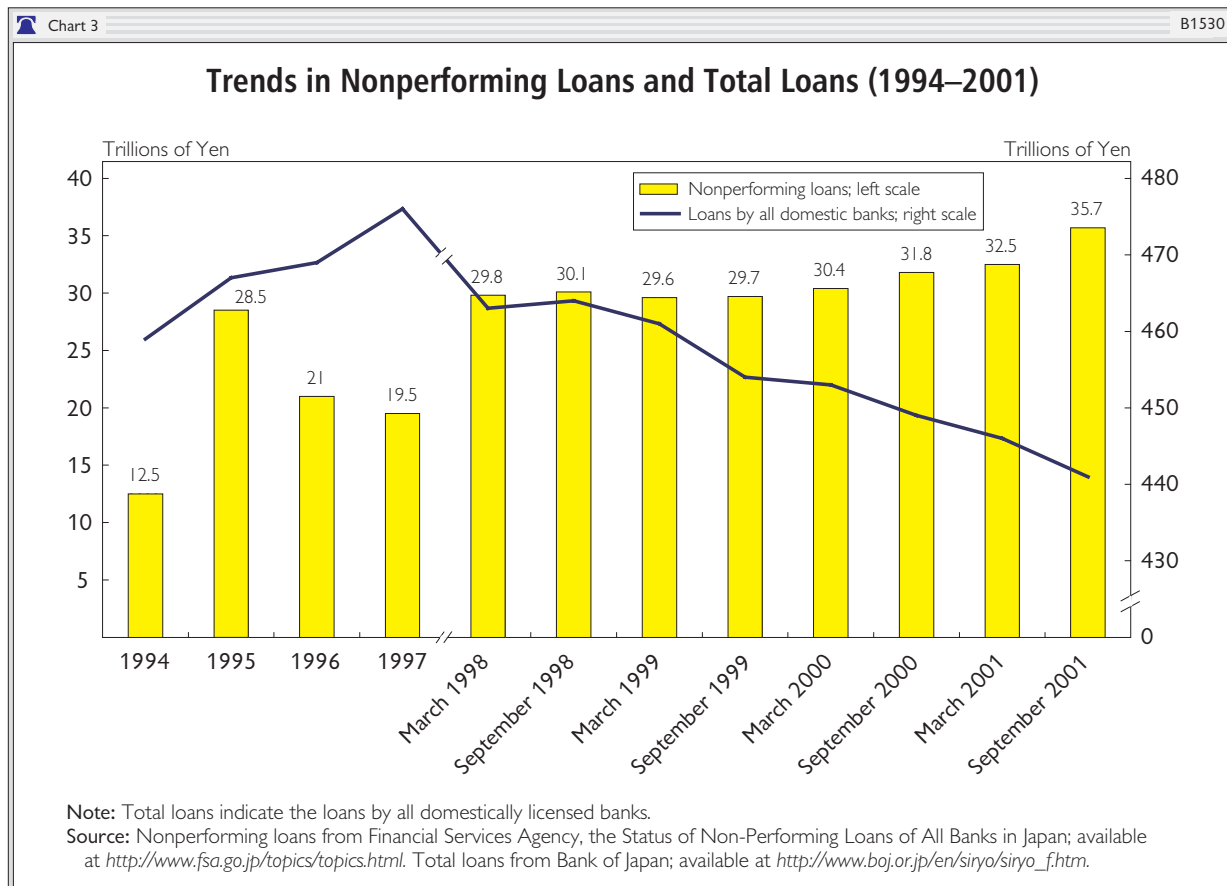
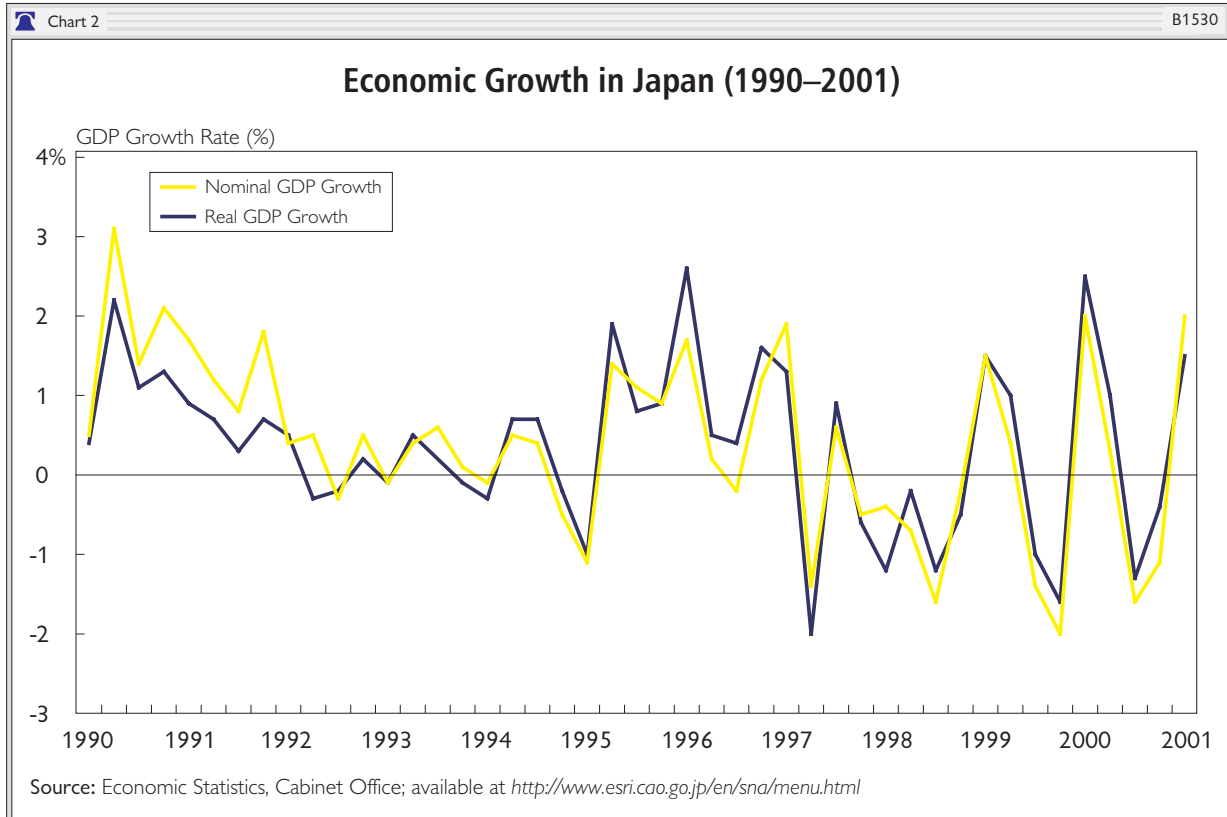
In Japan, however, because of political pressure and business relationships, banks were reluctant to foreclose on bad loans that would show a loss, choosing instead to maintain non-performing loans on the books. Worse yet, many extended new loans to bankrupt businesses. (See Chart 3.) As non-performing loans account for an increasing portion of overall bank assets, there has been a decline in new loans, since debt-ridden banks lack the resources to extend new loans while they keep non-performing loans on the books. Failure to resolve bad debt has weakened the overall health of the financial system and stymied economic recovery.

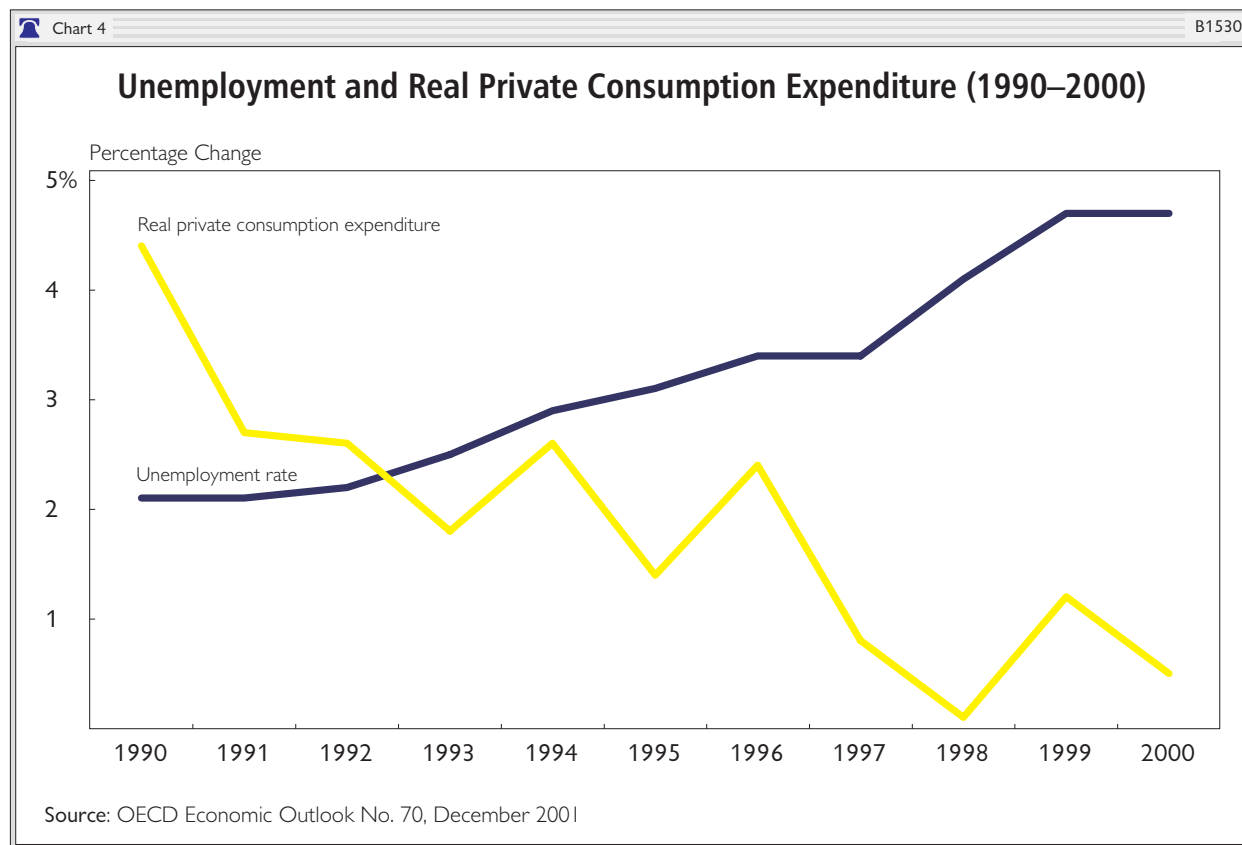
The *jusen*—hybrid subsidiaries comprised of banks and insurance and securities firms—illustrate the problem facing the Japanese economy. First established in the 1970s to provide consumer credit, the *jusen* instead became heavily involved in the real estate bubble in the late 1980s.

Despite clear evidence of widespread insolvency throughout the *jusen* after the bubble burst, the Ministry of Finance did not close down the subsidiaries; instead, it allowed them to continue to operate based on the assumption that real estate prices would rise—a speculation that proved ill-founded. A 1995 Ministry of Finance audit of the *jusen* "found that of the total ¥13 trillion [\$97 billion] of *jusen* assets, non-performing loans were estimated at ¥9.6 trillion [\$72 billion], of which ¥6.4 trillion [\$48 billion] was considered unrecoverable and

17. See Porter, *The Competitive Advantage of Nations*, pp. 384–394.

18. Description based on information in Cargill, "Asia's Financial Crisis and Japan."





¥1.2 trillion [\$9 billion] was considered a possible loss.”¹⁹

THE CURRENT MALAISE

Factors impeding the implementation of policies to address Japan’s economic problems include bureaucratic intransigence, lack of political will, powerful interest groups with much to lose under reform, and the relatively minor impact of the crisis on the daily lives of the average Japanese citizen. This last is particularly important because it explains the lack of outrage among the Japanese people regarding the government’s failure to take effective action.

Essentially, the Japanese government’s strategy has been to borrow from international capital markets and live off the capital built up during its industrial boom a decade ago rather than undertaking painful but necessary reforms, overhauling weak industries and forcing banks to revamp lending practices. This has allowed Japan’s citizens to

maintain their standard of living, concealing the true costs of the lost decade of growth.

As a result, despite the economy’s decade-long faltering, only in recent years has unemployment risen significantly and consumer spending fallen. (See Chart 4.) This delayed effect was the result of a government policy dedicated to propping up failing businesses to avoid restructuring and layoffs, which for a time allowed workers to continue their employment and consumption patterns.

The fact that unemployment has dramatically increased and consumption has decreased recently serves only to illustrate that government intervention can delay but ultimately cannot nullify the impact of poor economic performance. Instead of implementing the politically tough reforms necessary to restructure the economy and bring about a turnaround, the government has engaged in a series of ineffective stimulus packages and bailouts that have done little but increase the public debt, fur-

19. All yen converted to U.S. dollars at ¥134 to \$1—the exchange rate when this paper was being researched in mid-February. See Cargill, “Asia’s Financial Crisis and Japan.”

ther exacerbating economic recovery. (See Table 1 and Chart 5.)

Government expenditure as a percentage of GDP has risen by 20 percent since 1990 and government debt has nearly doubled, due largely to the costs of large infrastructure projects and bailouts provided for the banking industry. Not only has government spending provided no discernible effect on economic growth, but the immense burden of national debt has escalated to levels that now raise serious doubt about Japan's ability to service it.

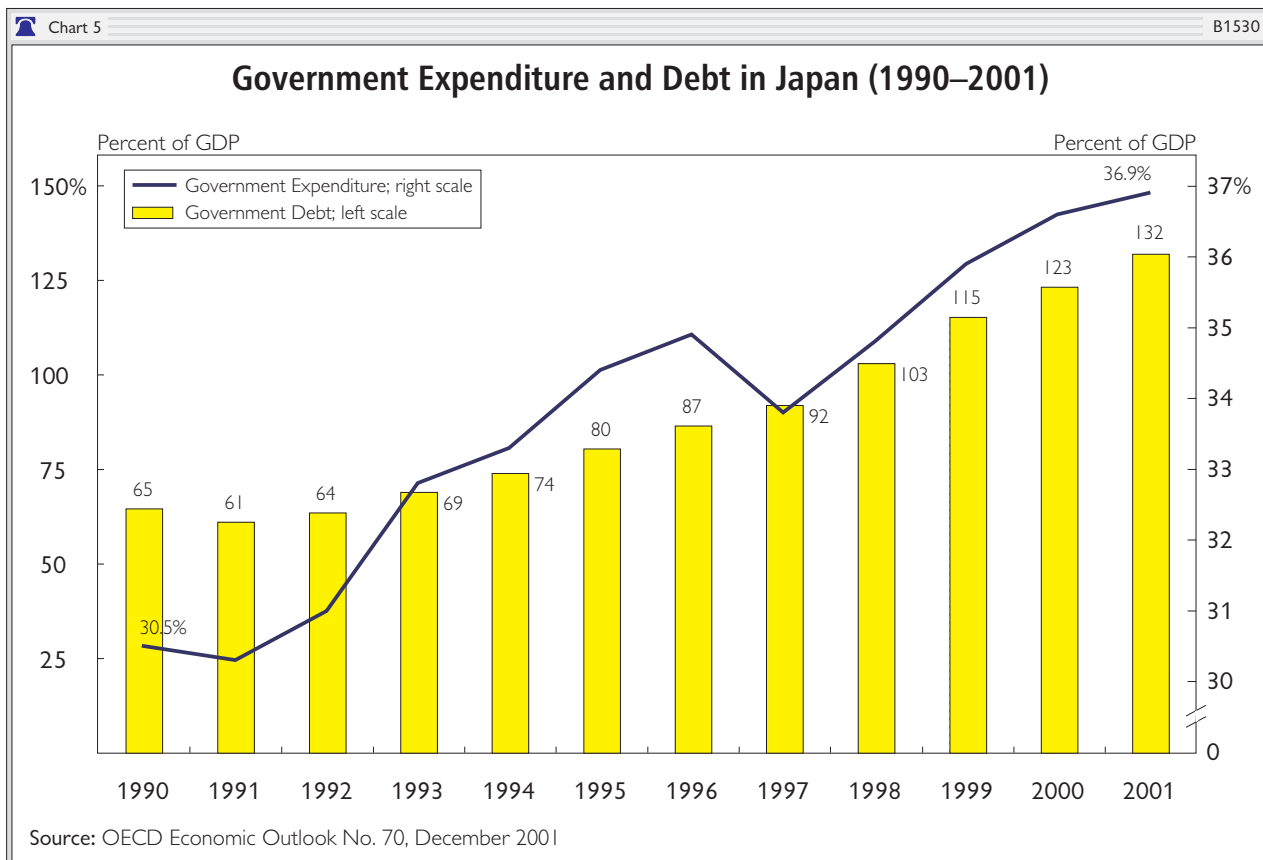
This deteriorating fiscal situation has been reflected in international sovereign credit ratings for Japan, which have been increasingly pessimistic. Since Japan was first graded in 1975, Standard & Poor's sovereign credit rating service consistently rated Japanese sovereign debt at the highest level. In the past year, however, Standard & Poor's downgraded Japan twice from AAA to AA+ to AA.²⁰ Moody's Investors recently announced that it may

Table 1 B1530

Japan's Economic Stimulus Packages in the 1990s

	Trillion Yen
1991, August	10.7
1992, April	13.2
1992, September	6.0
1993, February	15.3
1994, April	7.0
1994, September	14.2
1997, April	16.0
1997, November	17.0
1998, November	17.0
1999, October	11.0
Sum of Economic Stimulus (Trillion Yen)	127.4
US Equivalent (Billion US\$)	950.7

Note: Yen converted to U.S. dollars at ¥134 to \$1 – the exchange rate when this paper was being researched in mid-February.



20. Standard & Poor's, "Sovereign Ratings 2001: The Best of Times, the Worst of Times," at http://www.standardandpoors.com/Forum/RatingsCommentaries/Sovereigns/Articles/010902_sovereign.html.

further downgrade Japan's sovereign credit rating to that of the Bahamas and Botswana at A.²¹

While Japan's economic problems are not an imminent threat to international markets, there is no doubt that Japan's situation is worsening and that failure to reform will ultimately lead to a crisis. The situation will reach a point of crisis if Japan's sovereign debt rating falls below investment grade (BBB to AAA according to Standard & Poor's or Baa to Aaa according to Moody's). If Japan's sovereign debt should fall below investment grade, international investors would be reluctant to hold it and Japan would have to pay much higher interest rates to borrow in international capital markets. This would effectively put an end to Japan's budget policy of borrowing to finance domestic spending.

With the U.S. economy itself in a state of recovery, the Bush Administration must continue to pressure Japan to be aggressive in pursuing reform. After a decade of denying reality and refusing to implement the reforms necessary to spur a true economic recovery, the Japanese government must now undertake measures to salvage its own economy and ensure the stability of the global economy.

WHAT MUST BE DONE TO SET JAPAN ON THE PATH TO ECONOMIC VIABILITY

Prime Minister Junichiro Koizumi entered office in April 2001 on a wave of popular support for his campaign promises of much-needed reform. Nearly a year later, while political and economic reforms remain at the top of his stated agenda, little tangible progress has been made. Despite the efforts of his government, Japan has slid into its fourth recession since 1990 and unemployment has now exceeded 5 percent. Deflation is a reality, and non-performing private debt continues to hobble the banking system. In addition, extensive Keynesian-style stimulus initiatives through government-funded infrastructure projects have caused public debt to balloon.

The economic impact of a decade of lost growth is clearly illustrated by the decline of Japan's leading businesses. In 1989, reports *Business Week*, seven of the world's top 10 businesses according to market capitalization (including the entire top five) were Japanese. In 2001, not a single Japanese business was listed in the top 10 of the survey's list, and only two were in the top 25.²²

Japan's lackadaisical attitude toward resolving these problems over the past decade can no longer be ignored. The Bush Administration obviously cannot solve Japan's economic malaise. That task awaits action by the government of Japan, particularly the ruling Liberal Democratic Party and current Prime Minister Koizumi.

What the Japanese Government Must Do

The Japanese government must end the dangerous spiral of deflation. The latest GDP figures for the fourth quarter of 2001 reveal that there was a 12 percent drop in private-sector investment. This in effect nullifies a 1.9 percent increase in private consumption and a 2 percent rise in household consumption for the same quarter.²³ To prevent a skeptical public from becoming completely inured to the prevailing mood of political paralysis, the leadership must act quickly to:

- **Terminate ineffective Keynesian infrastructure projects.** Japan has spent nearly \$1 trillion on 10 different stimulus packages in the 1990s with no lasting positive impact on economic growth.²⁴ As a result of these expenditures, public debt has ballooned to nearly 140 percent of GDP—over \$6 trillion, the highest level of any major developed economy.²⁵ In Keynesian theory, it is assumed that stimulus packages will prime the pump for economic recovery, but Japan's strategy has increased debt without generating anticipated economic growth. This indicates that the spending was poorly invested

21. Peter Landers, Jason Singer, and Phred Dvorak, "Silver Lining? Amid Japan's Gloom, Corporate Overhauls Offer Hints of Revival," *The Wall Street Journal*, February 21, 2002, p. A1.

22. See "The Global 1000," *Business Week*, various issues.

23. Yuri Kageyama, "Japanese Economy Sinking Deeper into Recession," Associated Press Online, March 8, 2002.

24. Chikahisa Sumi, Counselor for the Ministry of Finance, Embassy of Japan, Washington, D.C., "Japan's Economic Woes and Its Impact on the Region," presentation at the Heritage Foundation, February 26, 2002.

25. James Brooke, "Some Japanese Are Hoarding Gold," *The New York Times*, March 14, 2002.

and, as a result, only further undermined the country's financial health.

- **Resolve the problem of non-performing debt.** Non-performing loans have accounted for an increasing portion of overall bank assets, resulting in a lack of funds to finance new loans that impeded recovery. Foreclosures are necessary to resolve these problems. The Resolution Collection Corporation was established in 1998 for this sole purpose. But the RCC has purchased and resold only \$139 billion in non-performing loans.²⁶ This amount is minuscule compared with the private sector's \$1.768 trillion estimate of non-performing loans. The RCC should be encouraged to be more aggressive in disposing of bad debt.²⁷
- **End government subsidies and protection for private businesses.** The government should end its support of the private sector, such as its implicit bailout of the debt-laden retailer Daiei. Instead, it should initiate legislative changes to encourage corporate restructuring and more flexible deployment of workers. In 1999, the government injected banks with \$56 billion of taxpayers' money to prevent them from collapsing but did little to encourage distressed corporate borrowers to downsize efficiently. That failure contributed greatly to the impending crisis in the financial sector.²⁸
- **Embrace free-market competition.** Japan needs to increase domestic competition by allowing large and inefficient businesses to fail unless they are restructured into slimmer, potentially profitable operations. This may entail painful mass layoffs, which traditionally are anathema to the Japanese. Competition can be further increased by deregulating and breaking up the old cartel structure of the nation's banking system. The government already has made efforts to further this goal with plans to end government guarantees of bank assets, but this reform measure has been delayed several times due to political pressures.²⁹ Prime Minis-

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Recovering from the economic problem acquired through 10 years of willful inaction is no simple task and will be accomplished quickly. However, failure to undertake these tough reforms will consign Japan's economy to a steeper decline that will lead ultimately to an economic crisis that harms other economies, particularly in East Asia, and further undercuts a shaky global economy.

What the U.S. Government Should Do

Reforming the Japanese economy is obviously a domestic Japanese issue that must be initiated, led, and managed by the Japanese leadership and people. Nevertheless, the United States can and should play a key role in assisting Japan in its turnaround by doing the following:

- **Provide unequivocal political support to Japan.** One of the most important tasks, and perhaps the only one available to the United States, is to provide vigorous support to the Japanese leadership. The momentum behind Prime Minister Koizumi's reform efforts has been waning in recent months, and the United States can do much to lend both credibility and a sense of urgency to the difficult tasks ahead. But the Bush Administration, instead of repeating the mistakes of the previous Administration, should refrain from badgering and bullying the Japanese on their lack of progress. In the past, such tactics were not only fruitless, but damaged the U.S.-Japan alliance. Rather, the United States should play a strong and positive supporting role.
- **Assist the Japanese leadership.** The Bush Administration should assemble a group of key

26. "RCC Buys Bad Loans from Three Regional Lenders," Jiji Press News Service, February 24, 2002.

27. Phred Dvorak, "Bad-Debt Disposal Plan Is Initiated in Japan," *The Asian Wall Street Journal*, January 28, 2002.

28. *Ibid.*

29. Jesper Koll, "Cause for Optimism: Three Cheers for Koizumi," *The Asian Wall Street Journal*, February 28, 2002.

economic and financial advisers to work with their counterparts in Japan to assist in financial reform. This group can provide key lessons learned from America's own savings and loan crisis in the 1980s and assist in the technical aspects of implementing new policies.

- **Communicate U.S. priorities to Japan.** The Bush Administration must make clear to the Japanese leadership that Washington will not overlook any lapses in financial, economic, and political reform in exchange for Tokyo's support of the American war on terrorism. While Japanese support in the war effort is vital, repairing the Japanese economy must take priority; a stable and prosperous Japan is the key to U.S. security interests in Asia.
- **Create an inter-agency task force in the Administration.** President Bush should consider creating an inter-agency task force, comprised of key officials from State, Treasury, Commerce, and the security organizations and coordinated by the National Security Council. Members of this task force could serve as a key advisory group for their counterparts in Japan and establish clear and direct channels of communication. More important, the task force would underscore the critical security aspect of restoring vitality and confidence in the Japanese economy.
- **Formulate a contingency plan.** Because the recovery of the Japanese economy is ultimately a Japanese and not an American task, the Bush Administration should, as a last resort, devise a contingency plan to deal with a possible crisis in the Japanese financial system. This plan must first work to ensure that the U.S. economy is not unduly exposed to a systemic failure in Japan and insulate the United States from the negative repercussions of a Japanese financial crisis. This means the Federal Reserve and other

banking regulators should ensure that the U.S. banking system is not unduly exposed to Japanese banks. Second, the President and Congress must work to strengthen the American economy, as well as to increase economic growth in the rest of East Asia and around the world, by adopting sound economic policies and promoting free trade. Finally, in the event of more serious Japanese downturn, the Bush Administration should state unequivocally that U.S. businesses and investors will not be bailed out. The East Asian financial crisis and the past decade of poor economic growth in Japan provide ample evidence of the risky nature of foreign investments, and U.S. businesses should take account of this evidence in their risk assessments.

CONCLUSION

Japan's economic performance in the past decade has clearly refuted the arguments of those who hailed Japan's economic system as superior to American-style capitalism. Japan's impending financial crisis belies such declarations as James Fallows' statement in 1989 that "Japan and its acolytes... have demonstrated that in head-on industrial competition between free-trading societies and 'capitalist development states,' the free-traders will eventually lose."³⁰

Rather than dominating the global economy, Japan is experiencing its fourth recession in a decade. Real estate prices have fallen to their 1982 value, leaving many people and businesses with mortgages greater than the value of their property. There have been four major bank bailouts since 1998. Whether Japanese industrial policy, protectionism, and autonomous bureaucracy contributed to Japan's rise or simply coincided with it, there is no doubt that these factors eventually destroyed Japan's economic vibrancy and are now hindering the country's recovery.

30. James Fallows, "Containing Japan," *The Atlantic Monthly*, May 1989, p. 54.

Japan's resistance to free-market capitalism is the source of its current malaise, and a failure to address this issue will make a future crisis in Japan inevitable. For the good of Japan and the global economy, the Bush Administration should work closely with the Japanese government and convince leaders of that nation to undertake long-delayed reform. If Japan is unable to forge a new path for recovery, its influence will continue to erode, and

the centrality of the U.S.–Japan relationship in Pacific affairs will correspondingly diminish.

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