



CAN JAPAN COME BACK?

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MISSION STATEMENT:

The Pacific Council on International Policy aims to promote better understanding and more effective action, by private and public sector leaders alike, in addressing a rapidly changing world. It brings together leaders from diverse communities across the western United States and around the Pacific Rim. Its focus is the interaction of global trends and local effects as national borders become more porous, traditional concepts of “public” and “private” blur, and what constitutes “policy” itself is changing.



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CAN JAPAN COME BACK?

*Report of the Pacific Council on International Policy Task Force on
Understanding Tomorrow's Japan*



PACIFIC COUNCIL ON INTERNATIONAL POLICY

THE WESTERN PARTNER OF THE COUNCIL ON FOREIGN RELATIONS

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EXECUTIVE SUMMARY

It has become conventional wisdom in the United States to dismiss Japan as a second-tier power facing a future of continued, perhaps deepening, stagnation. The headlines from Japan paint a bleak picture of bad loans, ballooning government debt, increasing unemployment and stock market losses. The political scene over the past decade has also offered little encouragement, with strong institutional obstacles to reform and mostly ineffective political leadership that fails to address pressing challenges. Japan's predicament seems all the more stark when compared to the apparent dynamism in neighboring China, with robust economic growth and a leadership willing to take risks to push the economy forward.

After a year of shared study by the Pacific Council's Binational Task Force on Understanding Tomorrow's Japan, we believe that the fashionable notion of a Japan in inexorable decline is misleading. Without question, there is a real possibility of continued stagnation, even decline, and our analysis considers these negative scenarios. But in our view, the recovery scenario has not been given the attention it deserves. There are important forces for change at work in Japanese society. If these are reinforced, the country is likely to find a new political footing and thereby regain its economic footing — and to become more assertive on the international scene. In short, it is a good bet that Japan will be back.

Japan Still Matters

The notion that Japan is now of little importance to Asia and the United States is dangerously wrong. Japan remains the world's second largest economy. It provides substantial financial backing to development programs worldwide, and to key initiatives such as the reconstruction of Afghanistan. Japanese foreign investment counts heavily in Asia and elsewhere, including the United States. The evolution of Japan's stance toward a vibrant China, the possible reunification of Korea, and strategic cooperation with the United States, will be a critical variable in shaping future Asian geopolitics. Japan matters, and the country's international partners will continue to have a keen stake in its renewed dynamism.

Persistent Economic and Political Travails

More than a decade ago, Japan seemed poised to assume a leadership role in the international economy. Observers spoke with some awe — and sometimes concern — about Japan as Number One. In retrospect, Japan's government-led industrial policy, with its emphasis on exports and scale, impeded the functioning of effective markets, and ultimately proved unsustainable. In recent years, there has been real concern about the possibility of a collapse, based above all on the large number of non-performing loans held by Japanese banks. Weak domestic demand and deflation are also part of this troubling economic picture. At the same time, Japanese society faces new and severe stresses from mounting unemployment and under-employment.

Japan's preferential political and economic practices have hindered the reforms and policy adjustments needed for economic recovery. Powerful vested interests in the political, bureaucratic and business sectors press to maintain the status quo and continue to obstruct real, urgently needed structural reform. The Japanese political system itself is also troubled and inspires little confidence or loyalty — with a resulting lack of leadership on critical issues.

Drivers of Change — and Recovery

Despite a decade of stagnation, several key trends can serve as drivers for change. Taken together, they reinforce the potential for recovery and augur well for Japan's future. Entrepreneurial small- and medium-sized enterprises promise to revitalize a Japanese economy stifled by stumbling corporate giants. Growing foreign investment in Japan is shaking up the old ways of doing business. Demographics are another

important driver — a shrinking population may force Japan to tap the formidable potential of women and immigrants, with potentially far-reaching implications for the economy and society. A new generation of Japanese reformers is attempting to overhaul a broken political system, and they will bring new approaches to the management of Japan's pressing problems.

As these forces for change gain momentum, there will be new opportunities for U.S. and global business in Japan, further fueling the globalization of the Japanese economy. But none of these trends will reach their full potential as agents of change in the absence of effective, government-led reform in the near-term.

A More Assertive and Sovereignty-Conscious Japan

Generational change is producing a Japan that is more national-minded and less anti-militarist. The Japanese debate over foreign and security policy has changed, and will continue to become more sovereignty-conscious, with greater attention to Japanese national interests. Revising Article IX of the Constitution that renounces the use of force is on the agenda, and Japan appears ready to allow its forces to operate under United Nations' auspices in areas of conflict. These changes may cheer the United States, which has long pressed Japan to assume a larger international role, but they are likely to discomfit Japan's neighbors in Asia, especially China and Korea.

... but a Continuing, If More Independent, Ally

In the future, tensions in Japan-U.S. relations are more likely to be about security than economics — a notable shift from past decades. After years of fairly routine discourse and cooperation on regional policies driven by Cold War needs and habits, security issues are set to become a more contentious part of bilateral relations. But with looming uncertainties about the intentions of Japan's powerful neighbors, especially China, and the rise of new transnational risks to both countries, the stakes in security cooperation have in no sense diminished. If Tokyo is now more reluctant to follow Washington's lead uncritically, and if some Japanese express concern about American unilateralism, these concerns are dwarfed by the continuing need for and mutual interest in strategic cooperation in the medium term.

Shocks, Wild Cards and Alternative Scenarios

Several potential shocks could quicken the pace of change and recovery. On the internal scene, a mid-level bank crash could spur Japan's leaders into action and set in motion a more rapid process of economic and political reform. Externally, new and dramatic milestones in the rise of China might stimulate a more rapid Japanese effort to restructure its economy — and might also lead to a more assertive set of regional policies. If such shocks do not stimulate an effective government response, however, Japan could cascade from crisis to crisis, moving toward scenarios of gradual or sharp decline. Other external factors, including slow growth or serious crises in the international economy, could also hinder Japanese recovery and make negative scenarios more likely.

The Way Forward

Our analysis suggests a number of policy implications and directions for Japan and the United States:

- *The Japanese government must do much more to encourage and reinforce the drivers of change that will make the economy more competitive.* In particular, Japan needs to create a more hospitable environment for new actors — small- and medium-sized entrepreneurs, women, immigrants, and foreign employers and investors.
- *If the new drivers of change in Japanese society are reinforced, foreign companies can anticipate an increasingly attractive climate for investment and for private sector partnerships.* The net result will be greater openness in the Japanese economy, and a more diverse Japanese engagement, both economic and political, in Asia and on a global basis.
- *The American approach to Japanese reform efforts should be constructive and cooperative, but focused on real structural reform.* The United States has an obvious stake in Japan's prosperity, and its ability to act as a capable international partner. But the United States needs to articulate this message, and its ideas about change, in a way that recognizes the validity of Japan's own social traditions. Japan is not the only advanced economy facing issues of transparency and reform — witness the recent corporate scandals in the United States. Overbearing advice and outright preaching will not help.
- *Greater transparency can help to prevent the reemergence of bilateral frictions over economics and trade.* There is a pressing need for new rules of the road to prevent a repeat of 1980s-style disputes over trade and competitiveness. At the moment, such frictions are in abeyance, but troubles in the American and global economy could put bilateral trade relations under new pressure. It will be especially important to prevent differences over trade and security matters from interacting and reinforcing one another.
- *Japan will benefit from a more open debate on the country's strategic relationship with the United States, and on its regional and international relations.* Policy decisions, including those affecting Japan's vital security arrangements with the United States, will of course be reached by government officials who have the responsibility for making them. Nevertheless, policy discussions conducted in a public forum by Japanese and American non-governmental organizations can enhance the knowledge and understanding of issues, and increase the sense of involvement of ordinary citizens in the policies of their governments, and thus should be encouraged.
- *Flux in the strategic environment, and changing policy debates in both Japan and the United States, argue for more serious, joint policy planning regarding defense cooperation and regional roles.* At this stage, given the uncertain security environment in Northeast Asia, both countries have a strong, continued stake in maintaining the American military presence in Japan. Ultimately, the strength and predictability of the security relationship will turn on its continued relevance to the evolving strategic concerns of both countries, including new and emerging challenges such as terrorism, missile defense, energy security, and the implications of possible Korean unification.

PREFACE

The Pacific Council on International Policy, an international leadership forum dedicated to understanding the global trends most salient to those residing in the western region of the United States, focused during 2001-2002 on Japan, the world's second largest economy and a country whose importance is often underestimated in the United States. The Council organized a Task Force of Japanese and Americans, seeking particularly to engage representatives of new forces in Japan, and those from the western United States. The result was a diverse and stimulating group, unlikely to come together under other auspices.

The Task Force met formally four times — twice in California and twice in Japan — to discuss commissioned memoranda, to hear commentary from experts and leaders, and to exchange information and ideas. It sought to identify those factors, external as well as internal, that will drive Japan's future over the next decade.

This report is the product of that collegial process, drawing on the Task Force's rich discussions. A report drafted by a truly diverse, binational group is bound to leave out some points on which unanimity could not be reached. No member of the Task Force, listed at the conclusion of this report, necessarily agrees with every statement in this text, and some take issue with specific points or lament omissions they consider significant. Some specific comments and reservations are included at the end of our report.

Personally, I would place particular emphasis on Japan's looming labor shortage, and the serious fiscal problem that will be created when the growing number of Japanese pensioners becomes too great for the shrinking labor force to support. I would also urge a much closer and harder look at ways to achieve greater political control of, and accountability from, the anonymous but powerful Japanese bureaucracy, to compel it to abandon its opposition to reform.

I strongly approve and encourage tax cuts and other specific pro-market reforms proposed in the Koizumi cabinet manifesto of July 2001, but also express concern and disappointment at the slow pace of their implementation.

And finally, while I see signs of growing nationalism and independence in Japan's foreign policy, I would not attach undue importance to them. I do not see them significantly undermining the long-standing security arrangement between Japan and the United States. Although the Task Force did not address geo-strategic issues in detail, it is my view that Japan may today well be at greater risk from powerful and potentially aggressive neighbors, and also be in greater need of American protection today than during the Cold War. That consideration outweighs all others today — and I believe it will a decade from now.

However, these points notwithstanding, all listed members of the Task Force do agree that this report draws faithfully on the group's deliberations and that it presents a thoughtful and balanced assessment of Japan's future, based upon shared enquiry. There is great importance in what we did agree upon: that Japan still matters today but its extended stagnation can ultimately be overcome only if serious reforms are undertaken; that demographic, economic, technological and international "drivers" encourage such reforms but by no means assure them; that astute and courageous political leadership will be required to convert the possibility of needed reform into a sustainable reality; so

that Japan still matters a decade from now — not only to its own citizens, but to the region, to the international economy and to the United States.

On behalf of myself and the Pacific Council, let me acknowledge the work of our able project managers, Gregory F. Treverton and Andrew Oros, who skillfully shepherded our discussions throughout, and the efforts of Dan Biers, who contributed greatly to the shape of the final report. Anne Beck, the Pacific Council studies assistant, and her successor, Jennifer Faust, kept on top of a thousand details that made the project, and Bill Moakler provided valuable research assistance. We also thank the members of the project's steering committee — Michael Armacost, Paul Crane Dorfman, Glen Fukushima, Abraham Lowenthal, Ronald Morse, Yukio Okamoto, T.J. Pempel, Tato Takahama, Akihiko Tanaka, Masakazu Toyoda, Steven Vogel and Tadashi Yamamoto, as well as Ian Lesser, the Pacific Council's new Vice President and Director of Studies — for their wise counsel and practical help. We also acknowledge the contribution of Raelyn Campbell, a former Pacific Council staffer, whose enthusiasm helped launch this project.

We are very grateful for the generous support furnished by All Nippon Airways, Sony, Union Bank of California, the Asia Foundation and the Ford Foundation. To them and their staffs we express our thanks. We express our special gratitude to Andrew Horvat, the Asia Foundation's Tokyo representative, for his advice and assistance.

Pete Wilson
Task Force Chair

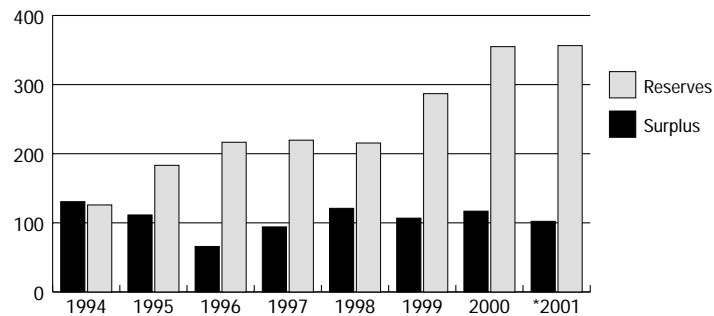


I. JAPAN MATTERS

Little more than a decade ago, when Japan was widely viewed as “number one,” soon to eclipse the United States in economic power, its importance went without saying. Now, it does not. With China rising, some see Japan as a second-tier power, of only modest relevance to the future of Asia and to the United States as a trading and strategic partner. That judgment, however, is wrong — dangerously so. Japan remains crucial to the global economy and the political future of Asia, and to the United States.

For all its difficulties in the past decade, Japan is still the world’s second-largest national economy. Its current account surplus, \$102 billion in 2001, is the largest in the world, and its foreign-exchange reserves, at \$400 billion, are twice that of the country in second place, China. (See Figure 1: Current Account Surplus and Foreign Exchange Reserves.). It still is a leader in providing official development assistance to developing countries, especially those in Asia. It still is a key bankroller for multinational initiatives, including many led by the United States: Tokyo, for example, pledged \$500 million for the reconstruction of Afghanistan, more than either the United States or the European Union. Direct investments by Japanese companies continue to play a huge role in the development of several national economies, most notably those in Southeast Asia.

Figure 1: Current Account Surplus and Foreign Exchange Reserves



Source: International Money Fund, *Japan: Economic and Policy Development*

An historically protectionist Japan still needs to afford greater access but remains an important market for the United States, especially for California’s hi-tech and agricultural exports. Although Japan’s domestic economy remains significantly closed relative to those of other industrial nations, foreign investment is welcome now more than ever before, including in service industries that once had the greatest barriers to overseas competitors. Even some of Japan’s most venerable firms have been acquired by foreigners. Ten years ago, it would have been unthinkable for France’s Renault to gain management control of Japan’s former flagship automaker, Nissan. But that is precisely what has happened, much to Renault’s profit and to Japan’s, as well.

Japan’s global influence is not limited to investment. Japan continues to be a world leader in high technology, a leadership based on an educated workforce and a history of product innovation. It has also become a major exporter of popular culture, particularly to the rest of Asia, where its television programs, music, food, and fashion have legions of fans. Indeed, it is not difficult to imagine Tokyo becoming the center of an Asian pop-culture and entertainment industry rivaling Hollywood in the Far East. Participation in various trade and security institutions, such as the Asia-Pacific Economic Cooperation (APEC) forum and the Association of South East Asian Nations (ASEAN) Regional Forum, further tie Japan to the region.

Japan's role in Asia will be the linchpin of the region's future, and it will have critical importance to the United States. Since its defeat in World War II, Japan has generally followed the United States in the realm of security. However, in the aftermath of the Cold War, attention to questions of national interest has been increasing in Japan, as has talk of revising Article IX of the Constitution. Article IX states that "the Japanese people forever renounce war as a sovereign right of the nation and the threat or use of force as a means of settling international disputes." To most Japanese, such developments are to be expected of a country that is a world economic power, but they have immense implications for the rest of the international community. Neighboring China and Korea worry about any constitutional revision as the first step to the reemergence of an expansionist Japan, this time perhaps armed with nuclear weapons. The United States, meanwhile, may find itself cheering on a Japan more willing to provide military assistance to U.S.-led campaigns, such as the war on terrorism, but also may worry that a more assertive Japan will put pressure on the U.S.-Japan Security Treaty, which has long been a cornerstone of stability in East Asia.

For the United States to mismanage the bilateral relationship risks compelling Japan to play a decisive role in nudging regional cooperation toward a pan-Asian model that excludes the United States rather than a trans-Pacific arrangement that includes it. Likewise, in this time of U.S. "unipolar" world dominance, which invites other nations to forge a coalition as a counterweight, Japan cannot be taken for granted.

For all these reasons, understanding tomorrow's Japan is critical — for Japanese and Americans alike; for those who would make government policy in Washington, D.C., Tokyo, Sacramento, California, or Olympia, Washington; and also for those who contemplate investment decisions or who seek to build global alliances among non-governmental organizations (NGOs) to promote humanitarian assistance, environmental protection, human security, or human rights.

The struggle between drivers of change and forces for the status quo has provided the focus and structure of this report. The report first describes how the entrenched powers in Japanese politics, business, and bureaucracy have failed a Japan that desperately needs to change. After a decade of macro-stagnation, internal forces are developing to drive change in Japan. These forces include shifting demographics, the growing presence of foreigners in the domestic economy, the vibrancy of small- and medium-sized enterprises, and the rise of a new generation of people who are more comfortable with engagement abroad and more independent in international outlook. Other forces are external, most noticeably the rise of China. The report next examines how these drivers of change will affect U.S.-Japan relations, and considers whether a shock to the country — perhaps the collapse of a mid-size bank or a suddenly more aggressive China — could accelerate reform or, conversely, hasten decline. We conclude with findings and policy implications for governments and the private sector.

How real and dynamic the internal forces for change are remains to be seen. While the need for political and economic reform is clear — indeed, urgent, as seen through the eyes of Americans and most Westerners — it is not at all clear that Japan has yet reached a tipping point in favor of reform.

Prime Minister Koizumi's immense initial popularity and the deep resonance that his reformist election campaign seemed to strike with Japanese voters notwithstanding, the type of political reform that is needed for sustained economic recovery is bitterly opposed within Koizumi's own party and remains uncertain. The resulting uncertainty over Japan's future

direction is unsettling to the United States and to the entire Pacific region. A keen student of Japan suggests, “Foreigners may lose interest in a Japan that has so lost interest in itself that it is content to drift.”

Such indifference is a luxury the United States cannot afford, either as a partner in security or in trade with Japan. In both the public and private sectors, American interests compel close monitoring of and interaction with their Japanese counterparts.

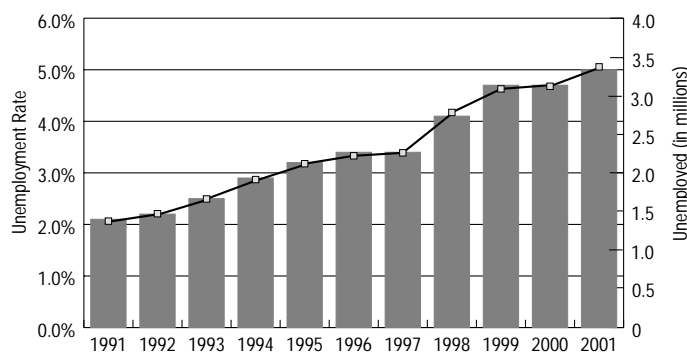
II. ECONOMIC TROUBLES

It seems only yesterday that “Japan Inc.” — the government-led industrial policy that emphasized exports, scale, and market share — was viewed with awe and more than a bit of fear by the rest of the world. Japan was seen by many as soon to overtake the United States as the world’s largest economy, an economy led by such companies as Sony, Toyota, and Matsushita. These developers of innovative, quality products — from Walkman audio players to Nintendo home games to Lexus luxury cars — captured the imagination of the entire world. The combination of a powerhouse economy, a remarkably stable government, and a cohesive society seemed unbeatable.

Japan Inc., as we now know, was not invincible. The successes it racked up obscured a crucial fact: Although some of Japan’s companies were very competitive internationally, most were not. Most depended on domestic protection and political patronage. This dependence set the stage for the great real-estate and stock-market bubbles of the late 1980s, when banks chasing a myth of infinite national growth pumped far more credit into the economy than it could handle. When the bubbles inevitably burst, Japanese banks suddenly were saddled with massive amounts of bad debt. More than a decade later, the country is still trying to recover from that financial implosion, but cannot do so without new financial direction and leadership.

The lingering aftereffects are manifest in the mountains of non-performing loans (NPLs) encumbering Japanese banks and the record levels of unemployment (see Figure 2: Annual Unemployment) that beleaguer an economy long known for its dedication to lifetime employment. The Japanese government estimates that resolving NPLs will cost \$250 billion; other estimates run as high as \$1.5 trillion. A figure of \$1 trillion may be reasonable. These estimates provide a very sobering context for Japan’s substantial current account surplus. With interest rates in Japan near zero, it is fairly cost-free to roll over the bad loans that pile up. The potential for a financial crisis triggered by bank failure remains a true threat overhanging the economy.

Figure 2: Annual Unemployment



Source: Ministry of Public Management, Home Affairs, Posts and Telecommunication Labour Force Report, Compiled by: Japan Institute of Labour

Adding to that threat is unemployment. Officially 5 percent, a figure Europe would envy, this unemployment rate is a record high for Japan, reflecting not only a country in a recession but

“What Japan most needs now is a new driver of growth on the demand side.”

an understatement of the truth, perhaps by half or more. The young have been especially hard hit. Almost 1 million 25- to 34-year-olds are unemployed — a latent political force waiting to be mobilized. (See Figure 3: Unemployment by Age 2001.) At Japan’s leading companies, hiring of newly minted college graduates is way down. The phenomenon of *freeta*, or “educated young people with odd jobs,” has taken its place. Some young people do professional work, consulting and the like, but most work in fast-food establishments or shops, waiting for an economic turnaround to find a job more commensurate with their skills.

Another labor problem is the growing ranks of the “living dead,” the popular name for employees who still get a paycheck but have little work to do. Sharp Corporation, for instance, has moved 40 percent of its production abroad but has not reduced its workforce by much in Japan. This practice is bad for the economy, keeping costs high and lowering the productivity of the nation’s overall workforce.

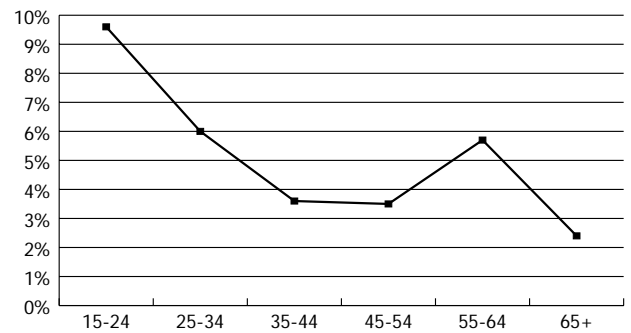
To make the labor market more flexible, Japan needs an improved unemployment insurance program for older workers who are laid off. However, such a program would require raising unemployment-insurance premiums from employees and companies alike — something that has not been part of the social contract in postwar Japan, where lifetime employment was considered the consumer’s return for tolerating economic policies that were mostly producer-oriented. To revise this social contract would require a major political move, something the ruling Liberal Democratic Party (LDP) has been unable to accomplish. Moreover, part of the improvement in unemployment benefits would have to come from an increase in the 5-percent consumption tax, a sure recipe for electoral defeat for any party proposing such an improvement.

In any case, the most important response is to institute policies to create economic and job growth, policies that will provide incentive to work rather than incentive not to.

What Japan most needs now is a new driver of growth on the demand side. The 1950s to 1970s saw the great rural-to-urban migration and booming housing construction. That exodus eventually slowed, and the oil shock of the early 1970s severely jolted the economy. Later in the 1970s, exports took off as a driver of growth. Then, in 1985, the Plaza Accord, an agreement among the monetary authorities of the major nations to revalue their currencies, resulted in a sharply revalued yen. Japan remained an export powerhouse, of course; but with the much stronger yen, many Japanese companies turned to manufacturing overseas, touching off an era of huge Japanese direct investment in Asia and beyond. At home, private investment led demand until the bubble economy finally burst.

So Japan in recent years has increasingly turned to public investment, marked by the infamous construction projects that dot the landscape, with more regard for political boundaries than local needs. With increasing debt, that investment surely is not sustainable. Japan’s debt,

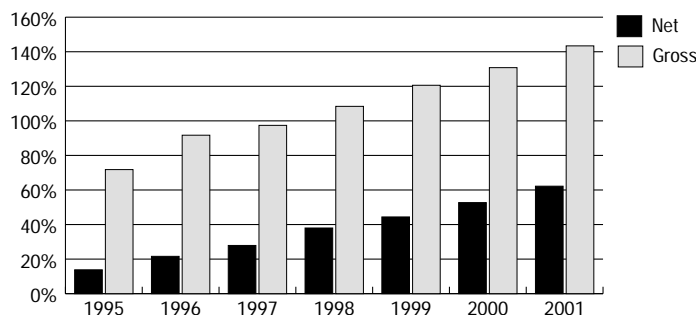
Figure 3: Unemployment by Age 2001



Source: Ministry of Public Management, Home Affairs, Posts and Telecommunication *Labour Force Report*.

measured as net liability, recently exceeded 140 percent of its annual gross domestic product (GDP), even higher if debt held by public corporations is included. (For comparison, U.S. government debt at its peak stood at 60 percent of GDP.) (See Figure 4: Debt as a Percentage of GDP.) Japan's debt has risen to 27 percent of all government debt worldwide, from only 17 percent in 1992.

Figure 4: Debt as a Percentage of GDP

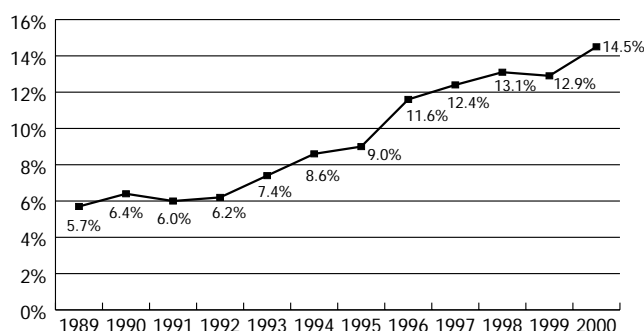


Source: IMF, *World Economic Outlook: Recessions and Recoveries*

To expect substantially more growth from any of these traditional drivers of demand is problematic. The lack of resolution of NPLs means that Japanese banks, which still account for 70 percent of external business finance in the country, cannot be counted on for fresh lending to jumpstart the economy. The new money that banks receive, including that from government bailouts, is used simply to pay down old debt. There is talk of the Bank of Japan intervening directly to buy commercial paper instead of operating through the commercial banks. However, this idea must overcome significant operational and political obstacles to be put into practice.

Increasing exports also is problematic. Japan's domestic industrial base has become hollowed out as more and more manufacturing moves abroad to take advantage of lower costs. Although this change is familiar to all industrial countries, and is of likely benefit to Japan and its neighbors, it means that Japan's most successful companies are less and less involved in the domestic economy. Some 15 percent of Japan's manufacturing base is located outside Japan already; that proportion was just 6 percent a decade ago. (See Figure 5:

Figure 5: Percentage of Manufacturing Capacity Outside Japan



Source: Ministry of Economy, Trade and Industry

Percentage of Manufacturing Capacity Outside Japan.) And key sectors, such as the electronics and automotive industries, have moved even higher proportions of their production overseas (33 percent and 25 percent, respectively). The move is rational: With the yen remaining much stronger than before the 1985 Plaza Accord, and with growing competition from such low-cost rivals as China, producing abroad is half as costly as relying on Japan-based factories.

Another alternative for boosting demand, increased government activity through taxing and spending, is possible in principle but politically doubtful. Japan now takes only about 38 percent of national income in taxes, about the same proportion as the United States and well below that of most European countries. However, increases in taxes and spending would require the government to improve its tarnished image with Japan's voting public. Voters are loath to trust increased tax revenue to the politicians and bureaucrats who are seen as being among the worst offenders in Japan's "structural corruption:" practices such as *kan-kan settai*, or bureaucrats using state money to lobby other bureaucrats; politicians diverting assistants' salaries for political

activities; and *amakudari*, or “descent from heaven,” whereby a retiring bureaucrat will move on to a position in a quasi-governmental agency, a public corporation, or a private firm in a sector that has close ties to the bureaucrat’s former ministry. Extensive press coverage of recent examples of such behavior has kept those practices in the public eye and deepened the distrust of politicians and bureaucrats. Makiko Tanaka was forced to resign as foreign minister after allegedly misusing her assistant’s salary, and Prime Minister Junichiro Koizumi has visibly battled bureaucrats who are protecting their vested interests and *amakudari* positions at public corporations, such as the Japan Highway Public Corporation.

One clearly needed alternative is to stimulate a rise in consumer spending. Consumption-led growth should have real potential, given Japan’s low private consumption — 54 percent of GDP compared with 68 percent for the United States. However, increasing private consumption would require changes in a tax code that now strongly encourages saving, and establishment of more realistic and reliable pension arrangements than now exist. Prime Minister Koizumi has explicitly embraced both such reforms, but many observers think their implementation unlikely. Pensions are financed by income tax, but the share of the tax needed to cover existing benefits would have to rise from some 12 percent to 38 percent in 20 years, something that Japanese citizens simply do not expect to happen. Shifting the financing of pensions from income taxes to consumption taxes might make economic sense; however, it, too, seems politically impossible to achieve. Remembering the political firestorm that arose the last time the consumption tax was raised, senior politicians made ironclad promises not to raise the tax again.

The other huge roadblock to increased private consumption is deflation. Prices have fallen by 5 percent in the past six years, a trend touched off by the global decline in inflation of the 1990s and by the strong yen, which makes imports cheaper. At the most basic level, consumers ask themselves, “Why buy today if products will be cheaper tomorrow?” Moreover, deflated real-estate values, which have left many Japanese in a position of negative equity, have contributed to personal fiscal restraint. Deflation hurts the economy in many other ways. It makes the NPL situation far worse, because every yen of debt becomes more difficult to pay off. It also eats into corporate profitability for similar reasons, and because revenue from sales often declines with declining prices.

Deflation is proving a particularly difficult public policy problem. Outsiders keep encouraging the Bank of Japan to print money. The Bank of Japan is doing so, and base money has been increasing rapidly since early 2001. If the Fed had done the same in the United States, the dollar would have collapsed in value and the bond market with it, sending inflation soaring. Yet the yen has fallen only modestly, in part because Japan’s broader money supply has grown slowly, if at all. The Bank of Japan has, in effect, been buying the problem assets of commercial banks to improve their balance sheets, but cautious Japanese bankers are still unwilling to resume fresh lending, an activity that all but dried up after the bubble burst.

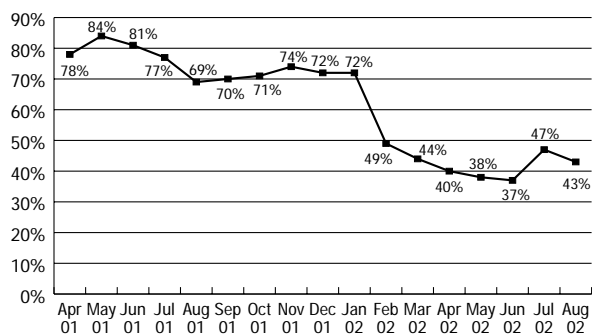
III. ROADBLOCKS TO REFORM

Japan's economic maladies make clear that Japan today is burdened by a number of out-dated political and economic practices. Yet, although reform is needed, powerful vested interests — primarily the senior political, bureaucratic, and corporate actors who have been powerful forces behind and beneficiaries of the anti-market practices — advocate the status quo, doing all they can to thwart structural change.

This impasse originates with those who hold the real political power in Japan: Actors accountable to sectors and individual patrons who view reform efforts as against their interests. Urban areas and productive sectors of the economy are underrepresented in this system, partly because of decades of gerrymandering of political districts, so that a popular chorus for change goes largely unheeded by the country's politicians. Political power resides with the senior members of the Liberal Democratic Party, who have strong personal links to senior bureaucrats and who control factions within the party from behind the scenes. This leaves Prime Minister Koizumi, who was chosen as party standard-bearer

through a rank-and-file revolt of local LDP branches and younger Diet (Parliament) members, with only a narrow power base of his own. As a result, he has been unable to get Diet approval for many of the reforms that won him support with the electorate. While Koizumi is still very popular for a Japanese prime minister, the failure to secure reforms has reduced his approval ratings from the incredibly high level of support he enjoyed upon taking office, and has made him more vulnerable and exposed within the party. (See Figure 6: Support for Koizumi Cabinet.)

Figure 6: Support for Koizumi Cabinet



Source: Asahi Shimbun
Compiled by: Masahide Kanzaki (www.kanzaki.com)

The powerful senior Diet members have risen to their positions of prominence not on the strength of their political ideas but on their ability to win government spending and support for their constituents, as well as for the businesses that fill their campaign coffers. It is no surprise, therefore, that under these circumstances many politicians inherit their fathers' constituencies and Diet seats. Koizumi himself is a third-generation politician, despite his popular image as the symbol for new political practices. The three *bans* of Japanese politics — *jiban*, "local base"; *kanban*, "name recognition"; and *kaban*, "the bag," or financial resources — remain all-important.

In particular, *kaban* is still of great consequence. Many of the big companies that have supported the LDP throughout its 40-plus years in power continue to be rewarded for their personal and financial connections to senior politicians. This practice helps explain why the government's response to an anemic economy over the past decade has been primarily to spend billions of dollars on dubious public-works projects — for instance, little-traveled roads and bridges in rural areas, where the LDP is particularly strong. These projects have been a windfall to construction companies, which are traditionally among the biggest contributors to the ruling party.

“Although reform is needed, powerful vested interests advocate the status quo, doing all they can to thwart structural change.”

“No Japanese political party has put sufficient effort into effecting a clear reformist agenda that resonates with popular demands for change.”

Americans in too many states well know and continue to suffer gerrymanders, but Americans are protected against the dilution of their vote by the U.S. Supreme Court’s famous ruling that the U.S. Constitution requires “one man, one vote.” In Japan, the LDP has remained in power since its formation in 1955, in part through the disproportionate weight of the rural vote, upheld by the Japanese Supreme Court ruling that vote disparities of up to 3 to 1 are acceptable.

Many senior politicians have shown no interest in the bolder measures that many Japanese, including some bureaucrats, say are essential to getting the economy back on its feet. For example, the government’s Financial Service Agency should opt to abandon the “command” approach to NPLs, whereby it seeks to regulate specifically which loans will be resolved on what timetable. Instead, it should engage in market workouts, giving banks discretion in using government funds in determining how and when to resolve problem loans through a secondary market. It might also jail some executives who commit particularly egregious cases of obfuscation of bad loans, as a signal of government commitment to resolve the problem quickly, then give amnesty to the rest. It also must allow large failed employers to go bankrupt, as it did the chain-supermarket operator Mycal, instead of using public funds or encouraging lead banks to prop them up. Among other needed changes are cuts in subsidies and other wasteful government spending, tax reform, privatization, and measures that encourage private equity investment.

No Japanese political party has put sufficient effort into effecting a clear reformist agenda that resonates with popular demands for change. Hence, citizens become apathetic, choosing to refrain from active political participation. Voting rates, traditionally quite high in comparison to other advanced democracies, are at all-time lows. The main opposition party, the Democratic Party of Japan (DPJ), receives less than 10-percent support. The LDP does better, but gets only about 25 percent. Indeed, disaffected voters have taken to casting protest votes, resulting in 40 parliamentary seats for the Japan Communist Party, which campaigns on the promise of remaining outside a coalition government. Ironically, Prime Minister Koizumi’s initial widespread popularity may actually hurt the cause of reform he champions, because it has prolonged the life of the LDP he nominally leads. The real powers within his party, the conservative senior members, want no part of reasonable and clearly needed change.

The result is a Japanese political system that inspires little confidence or loyalty. The system is characterized by little innovation, seemingly endemic corruption, and weak leadership: Japan has had 11 prime ministers since 1987, nine of them since 1989.

Koizumi captured the imagination of the voters in his campaign. The question now is, “Can he capture or reshape the Japanese political apparatus to bring long-needed change and confidence to the Japanese people?” To begin answering this question, we next consider what forces are at work that should help him — or a successor who ultimately makes good on Koizumi’s reformist campaign rhetoric — to do so.

IV. DRIVERS OF CHANGE

Without dramatic change, Japan is commonly portrayed as on its way to certain decline and irrelevance. Yet, tomorrow's Japan is likely to depart markedly from this conventional outlook. Beneath the economic and political problems are forces that already are bringing change to Japan, a process that is likely to accelerate in the coming years. The critical question is, "Can these forces overcome those that sustain the old system — and, if so, when?"

To start with, persistent economic problems have led some Japanese to question the mainstays of their political and economic practices. The result is that Japan is gradually moving toward promoting a greater role for market forces and for transparency in government. Such a transition suggests a more openly competitive society, one that is at odds with the social harmony and relative income equality that have been hallmarks of postwar Japan. Japan is heading in this direction because many of its people have come to the conclusion, haltingly and unevenly, that the model that made the country rich after its defeat in World War II no longer serves its varied interests and aspirations. The Japanese are looking to varied sources for new inspiration, however, not just to a single "American" model.

On the corporate governance side, the government hardly has been paralyzed. If anything, it has acted faster than the majority of companies — the Sonys and Nissans of Japan notwithstanding. The government ended the ban on holding companies in 1997, which paved the way for large-scale bank mergers and corporate restructuring. Several revisions of the Commercial Code, as well as new bankruptcy procedures and other new legislation, were aimed at introducing more transparency and accountability into the country's system of corporate governance. As a result, some firms have reduced their boards of directors and have started to add real outsiders to them, thereby introducing some independent voices to the boardroom (admittedly, many of the newcomers are famous CEOs or well-known scholars).

Corporations have been reducing their dependence on their lead banks as corporate financing has become more diverse, another change that has been furthered by the large-scale bank mergers since 2001. Some of these mergers have blurred what used to be clear-cut lead-bank relations, and the separation of companies from their main banks has sometimes coincided with a reduction of cross-shareholdings among member firms of *keiretsu*, the large business groups centered around big banks. Although accounting-rule changes have made data ambiguous, it seems that some *keiretsu* are becoming less cohesive. This situation may, in turn, make the trade relations among firms within *keiretsu* less preferential, weakening the strong barriers to entry once erected for foreign firms and basing economic decisions more clearly on market forces.

Still, much of the old system remains. While cross-shareholding has diminished within the *keiretsu*, these groups have hardly disappeared. Banks still account for 70 percent of external financing for Japanese firms, compared with 30 percent in the United States — although many large firms in Japan today must make do with no external financing at all.

On the labor front, too, legislation is driving changes, including a 1998 law providing for overtime and more flexibility, and 1999 legislation authorizing temporary workers. More big businesses are hiring new employees from nontraditional sources, such as schools other than the preferred elite universities, and women and immigrants. They are also putting emphasis on

"Japan is gradually moving toward promoting a greater role for market forces and for transparency in government."

recruiting specialists, not the generalists of old who received all their job training from the company itself.

But another vestige of the traditional labor system, lifetime employment, remains a reality at many firms — although it is no longer axiomatic. It is still uncommon for employees to actually be terminated from their jobs. With weak unemployment safety nets, turning labor loose carries a high social cost: High-value labor often remains trapped in low-value companies, since workers are reluctant to give up de facto job security to participate in new ventures. Japanese firms typically are cutting labor costs through attrition and transfer of workers to other jobs within the company or affiliated firms, and through hiring more part-time or temporary workers, mainly women, who have no expectations of lifetime employment.

For all of the legislation to date, far more needs to be enacted. Tax reform that stimulates entrepreneurship and innovation, for example, is needed instead of subsidies that now mostly go to “sunset” industries that already have seen their heyday. However, many Japanese firms have not been taxed at all in recent years; therefore, such a stimulus would be somewhat mitigated. New accounting laws and practices are needed to restore trust in Japanese companies that cannot raise funds because of their suspect books. Indeed, corporate corruption is still worse in Japan than in the United States, the Enron debacle notwithstanding. And the postal saving system, which still captures about a quarter of all individual savings, needs to be overhauled so that market forces, not government bureaucrats, determine where the money is invested.

Even if entrenched politicians and Japanese captains of industry are loath to go any further in the direction of reform, forces are already at work to renew dynamism in the economy, society, and politics. Just as these drivers of change are both internal and external, so, too, will their effects be felt both at home and abroad.

Changing Demographics

One of the biggest drivers of change in Japan will be shifting demographics — the aging and shrinking of the population. The number of Japanese between the ages of 15 and 65 began to decrease in 2000. Within several years, the entire population will begin shrinking. Perhaps more serious, the net outflow of Japanese is estimated at 130,000 per year, and their average age is 38.5, just at the cusp of high productivity.

This demographic trend is particularly disturbing, given that Japan today already confronts labor shortages in certain industries, even with more than 3 million people unemployed. The shortages reflect a mismatch between the generalists that Japan’s educational system produces and the specialists its economy now requires — from nurses to engineers to lawyers. For example, to have bankruptcy laws on the books opens the way for uncompetitive firms to exit in an orderly fashion from business; however, converting that law into practice has been stymied by the lack of lawyers: By one count, the country had only 31 bankruptcy lawyers when serious discussion of addressing NPLs began in the mid-1990s.

In the short term, the shrinking Japanese labor pool will lead to increases in retirement ages; in the longer term, changing demographics will force a rethinking of the role of women and immigrants in society, two sources of labor that until now have gone largely untapped.

Women: The Undervalued Asset

Women still play only a marginal role in today's Japanese economy. The number of women running companies or having a seat in corporate boardrooms is small. For example, the board of Shiseido, a cosmetics maker that caters to young, stylish women, is made up exclusively of males, many of them elderly.ⁱ While the gender gap in corporate executive suites is narrowing in other nations, the proportion of women executives in Japan has remained unchanged for roughly the past decade.

Women continue to be more vulnerable than men to economic downturns. When second-tier regional banks crashed in 1995, they let women go first in order to keep men employed — perhaps an outcome of too little education as much as of gender. When they are able to create a career for themselves, women take home paychecks only about two-thirds the size of those received by men in comparable jobs. Little wonder, then, that women, mostly the well educated, account for about 70 percent of Japanese emigration.

Certainly, there is plenty of room for the growing participation of women in the Japanese economy. Foreign companies already are aggressively courting women to join their workforce. Bringing more women into corporate Japan would require enforcing existing laws and, perhaps, adding such social services as daycare. But, importantly, such changes also require shifts in predominant attitudes in today's Japan. Existing success stories suggest that a growing role for women in the economy would have a huge payoff. One example is the wildly popular i-mode cell-phone Internet service provided by NTT/DoCoMo, which was developed by a woman — and one coming from a non-technical background.

Immigrants: The Solution to an Impending Labor Shortage

Immigrants figure even less in Japan's economic equation today than do women. Only 0.2 percent of Japan's population is foreign-born — compared with 20 percent of Australia's and 12 percent in the United States — despite the fact that the United Nations estimates that Japan will need 600,000 immigrantsⁱⁱ per year to fill its labor shortages. Japan has always been an insular nation and has generally tended to make immigrants feel unwelcome; indeed, in the 1990s, new government actions to regulate the inflow and status of foreign workers drove many such workers underground. This insularity has deprived Japan of a potential gold mine of human capital that many other countries have enjoyed in industries ranging from nursing, for which Filipinos fill shortages from Hong Kong to the United States, to high-technology, to which Chinese and Indian engineers have made huge contributions.

Whereas some countries have imported immigrants to work in domestic plants and factories, Japan has exported firms to take advantage of cheaper labor in much of the rest of Asia. But this cost savings comes at a serious hidden cost: Within this decade (2000-2010), Japan's aging population and shrinking labor force will combine to produce a crisis in the government's ability to pay for its obligations in retirement benefits. As a very unhealthy ratio of fewer workers to support more benefit recipients worsens each year, it will sharply aggravate Japan's already-serious fiscal problems. An infusion of foreign workers could change that ratio.

The example of Silicon Valley in California, where skilled immigrants played a crucial role in its emergence as the global center for technological innovation, provides a striking contrast. Almost a quarter of the Valley's population is foreign-born. Furthermore, a 1999 study found that immigrants accounted for one in three technology workers in the Valley.ⁱⁱⁱ Many of them possess a strong entrepreneurial flair; executives with Chinese or Indian surnames lead about one

“Insularity has deprived Japan of a potential gold mine of human capital in industries ranging from nursing to high-technology.”

quarter of the Valley's technology firms. Close to 3,000 Asian-owned companies produced \$16.8 billion in sales in 1998, employing more than 58,000 people, or about 14 percent of the Valley's high-tech workforce.

The central role of foreigners in the Silicon Valley story is among the reasons some Japanese leaders are coming around to the idea of easing restrictions on immigrants. Among those who have urged a rethink on immigration policy in recent years have been the chairman of Toyota Motor Company, the head of the Economic Planning Agency (which recently became part of the Cabinet Office), and even some officials within the Ministry of Economy, Trade and Industry (METI). Indeed, it is possible to imagine that immigration, especially of skilled Chinese, would be welcome once the bite of labor shortages is really felt. However, one potential roadblock is the fear among many Japanese that increasing immigration would lead to increasing crime.

Foreign Investment and Management

The vibrant role of immigrants elsewhere underscores the importance of fresh faces and fresh practices, as well as alternative patterns of social and economic organization. As internal sources of capital have dried up and the past formula for success has become unbalanced, Japan has slowly opened up to foreigners to provide cash and new management philosophies to revitalize the economy. This phenomenon is likely to grow in the coming years and accelerate convergence between U.S. and Japanese systems.

Foreign direct investment (FDI) has risen sharply in Japan in recent years as barriers to entry have fallen, although it is still minuscule by international standards. Before Japan's "big bang" opening of financial markets in the mid-1990s, FDI in the United States and Europe ranged between \$1,500 and \$3,500 per capita; in Japan, it was a paltry \$48. Within the last year or two, the range from other countries was \$1,700 to \$8,000 in the United States and Europe; in Japan, it was \$198. Thus, although quadrupled, FDI in Japan is still quite low, relatively speaking. Much of this divergence had been the result of long-standing Japanese government practices aimed at keeping businesses under national control.

One reason why many foreign investors still shy away from Japan is that they are forced to compete with Japanese companies whose inefficiency is subsidized by the government. In the United States, businesses that are not competitive fail. In Japan, however, bankruptcy remains rare. The resulting excess capacity has driven down profitability. In retailing, where few domestic firms fail and productivity is low, foreign ventures have mostly failed. Toys "R" Us is one notable exception, and it is too early to tell about recent entrants, Carrefour and COSTCO.

Yet, Japan's increased willingness to try new approaches has attracted more and more foreign investors. New approaches include a growing sense of entrepreneurship, unleashed by extended economic and political stagnation, and new opportunities created by struggling corporate behemoths spinning off or divesting themselves of non-core businesses. Some of the new foreign investments are going into Japanese start-ups that hold particular promise for the future, including in telecommunications and other high technologies. One Silicon Valley-based venture capitalist recently invested \$7 million in a Japanese firm set up to develop mobile-commerce technologies. Another teamed with Toshiba to pursue technologies spun off from that Japanese electronics company, including wireless and imaging projects.

Other foreign investments are targeted at mature industries — most notably, the auto industry. Seven of the top-10 Japanese carmakers have foreign partners, and three of those — Nissan, Mitsubishi, and Mazda — are essentially foreign-controlled.

The positive influence of hard-nosed foreign management is even more important than foreign investment. Global markets and networks have created great pressure on Japanese companies to restructure to increase their competitiveness. This is most obvious at Nissan, the Japanese automaker that, in desperation, turned to French carmaker Renault in 1999 to stanch a growing tide of red ink. Renault veteran Carlos Ghosn, a Brazil-born, France-trained executive of Lebanese heritage — a stark contrast to the stereotypical CEO in Japan — led the makeover. In just three short years, Ghosn has challenged existing norms on several fronts. At Nissan itself, he announced an English-only policy, bulldozed plants, and downsized the workforce in a bid to boost profitability.^{iv} He has been wildly successful: In May 2002, Nissan announced record earnings of \$3.8 billion.^v Just as important as earnings, his example has had a broader impact on corporate Japan. Other Japanese carmakers have followed his lead and cut back on production or restructured their capacity. Ghosn's announcement soon after his arrival that Nissan would deal with fewer steel suppliers sent a ripple down through the supply chain, and Japan's big steel companies announced their own restructuring moves in response.^{vi}

Today, Ghosn has become a pop figure in Japan. His Japanese-language biography is a bestseller, and his character appears in *manga*, the comic books that are avidly read throughout the country. His legacy for Japan could be profound. Clearly, foreign employers already are looked upon more favorably by Japanese than in the past. Headhunters report that, whereas a decade ago only about one middle manager in 10 was willing to talk with a foreign company about career opportunities, the vast majority is now willing to do so. In a recent poll of the most attractive employers for young people, Sony ranked first, but three of the top 10 were foreign: Microsoft, Citibank, and Yahoo!.

Women, in particular, are finding opportunities at foreign companies that have not been available at most Japanese firms. At IBM Japan, for example, women now account for about 40 percent of new hires.^{vii} The company created a Women's Council in 1998 to help female employees climb the ladder to upper levels of management; all of IBM Japan's female employees attended forums organized by the council during the following two years.^{viii}

New Dynamism in Small- and Medium-sized Enterprises

Opening the door to more immigrants and to foreign participation also would help energize an area that many experts see as key to Japan's economic future: small- and medium-sized enterprises (SMEs), companies that employ fewer than 300 workers for manufacturing industries and even fewer for other types of industries (see definition in Table 1 below). They already account for over two-thirds of total employment in Japan and 99.7 percent of all business enterprises. (See Table 1: SMEs' Share of Employment and Sales.) While not all are economic dynamos — more than half are tied to larger firms, and many more are linked to troubled sectors, such as real estate and construction — there is good reason to expect that they could be a source of growing economic vitality.

Table 1: SMEs' Share of Employment and Sales (1999)

	Number of Enterprises		SME % of all Firms	Number of Employees		SME % of Total Employment	SME % of All Sales
	SMEs	All Firms		SMEs	All Firms		
All SMEs	4,836,764	4,851,104	99.7%	27,073,03	40,773,25	66.4%	—
Wholesale	293,903	296,162	99.2%	2,613,429	3,734,037	70.0%	62.3%
Retail	1,084,209	1,087,993	99.7%	3,886,631	6,123,121	63.5%	73.3%

Source: Japan Ministry of Economy, Trade & Industry, White Paper on Small and Medium Enterprises in Japan 2001.

* SMEs are classified as having fewer than 300 employees for manufacturing industries, fewer than 100 for wholesale enterprises, fewer than 50 for retail and fewer than 100 for services.

Many of Japan's large companies have curtailed hiring of recently minted college graduates as part of their effort to reduce workforces without firing current staff. Therefore, a lot of talent that historically has gone to large firms, and has had its entrepreneurial inclinations deadened by corporate bureaucracy, must now turn elsewhere for employment. Examples abound of many 20- and 30-somethings starting up or joining small businesses. In recent years, the Internet has provided an unprecedented opportunity for such younger, tech-savvy Japanese to go into a field not already dominated by the corporate behemoths^{ix}. It is precisely these budding entrepreneurs that have caught the attention of, and sometimes obtained seed money from, foreign venture capitalists.

The hope is that these entrepreneurs will be the driving force behind the next Sony, the famed global electronics maker that began life as a Japanese SME. Recognizing the importance of sustaining the "DNA" of an SME even though it has grown to about 170,000 employees worldwide, Sony conducts research and establishes joint ventures with small firms to help it come up with new products.

Japan's economic prospects would be helped if the government developed successful strategies to nurture young SMEs. As it now stands, METI does not effectively foster such companies, although it has made many attempts, including enacting eight new laws in the past five years to support SMEs and start-ups. In trying to promote such businesses, it confronts head-on the slow involvement of universities in R&D activities and, more broadly, a culture that, for the most part, still resists entrepreneurship and individual risk-taking.

The New Generation

Younger Japanese will not only supply a jolt of entrepreneurial verve to the economy but will drive change in Japanese society in many other profound ways, some with direct implications for U.S. interests in Asia. Consider the following:

Technology: The New Frontier

So far, an e-communications revolution has yet to materialize in Japan, in part because of cultural factors and resistance from the Japanese old guard. In the public sector, for example, e-communication threatens a proud and effective officialdom. Not surprisingly, most e-government initiatives drive in one direction — helping citizens make life easier for the bureaucracy. So far, there is not much emphasis on making it easier for citizens to actually communicate with their government, as opposed to simply fulfilling government formalities online.

In business, information technology (IT) promises more transparency, more competition, and more accountability, all pointing toward greater efficiency and lower prices. Yet, the country has lagged, especially in business-to-consumer e-commerce. One explanation is that, until recently, the NTT telecom monopoly drove prices up, making online transactions less attractive. In addition, the use of computers, English, and credit cards has remained low in Japan. And if an e-commerce transaction goes awry, there is no ready access to courts.

Given the stigma still attached to layoffs and the general risk aversion in Japanese society, media coverage of IT tends to emphasize the negatives — such as the job losses that occur when information technology boosts efficiency — rather than the positives. For instance, reaction to the fact that fewer than 5 percent of Japanese airline tickets are purchased online (as opposed to more than 60 percent for some U.S. airlines) was less to lament the lag than to worry about travel agents who might be laid off if e-ticketing took off. This worry mirrors concerns that slowed the acceptance of automated teller machines a decade ago.

While technical obstacles to being a more wired nation are significant, it is the human factor that matters most in the adoption of IT. Japan could reach its goal of becoming the most-wired country in the world, but it would matter little if connectivity remains marginal to the Japanese lifestyle. Expanding the use of the Internet clashes with a whole set of traditional customs. Although sending e-mails to strangers, even important ones, may come naturally to Americans, it certainly does not to most Japanese, for whom good manners dictates initial contact in person.

Nonetheless, attitudes toward the use of technology are changing, most visibly among the young and those who have had international exposure. The explosion of mobile devices for Internet access — most notably DoCoMo’s i-mode cell-phone system — has spawned an army of Japanese teenagers with agile thumbs and a high comfort level for e-communications. How effective such small devices can be for engaging the full resources of the Web remains to be seen. Since information technology can subvert the social hierarchy and corporate loyalty that have been traditional hallmarks of Japan, it should begin to undermine the old ways of doing business as it is embraced by upcoming generations.

The Political System: It’s Broke; Who Will Fix It?

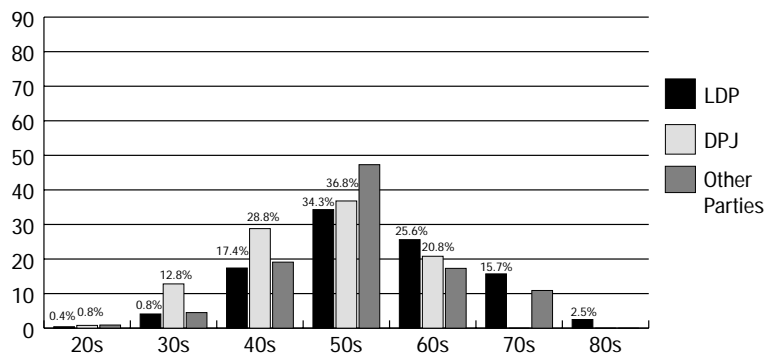
Generational change also is likely to have important implications for Japan’s political class. As noted above, the political system is clearly broken, unable to provide visionary leadership now that many of the old social and economic structures no longer serve the country well. Much that is broken can be traced to the failure of the Liberal Democratic Party, which has been synonymous with government for most of the postwar era and which continues to be the most powerful political party.

Typically, the path to power for politicians led upward through the LDP ranks as a protégé of a powerful party-faction leader. Intraparty promotions favored seniority over ability, which in turn worked against the rise of dynamic, charismatic politicians as prime ministers, because a popular head of government would upset the delicate balance between factions.

After the 1993 first-time loss of government control since the Liberal Democratic Party’s creation in 1955, party leaders realized that they would no longer automatically control both houses of the Diet. This realization placed great strains on the political system. More power-sharing with other parties and changes in the electoral system have allowed less-traditional politicians — including those who are younger — to gain prominence. Younger backbenchers, along with party leaders at the local level, were largely responsible for pulling off the rank-and-file revolt that propelled reform-minded Junichiro Koizumi to LDP leader and prime minister against the wishes of senior party officials.

Today, slightly more than a tenth of members of the Diet’s lower house were born after 1960 and can be said to be part of the up-and-coming generation of politicians. A large number of these younger representatives were elected under the banner of the opposition Democratic Party of Japan, accounting for a full one-fifth of the DPJ’s seats in the lower house. By contrast, the LDP has as many Diet members over 70 as under 45. (See Figure 7: Lower House Members by Party and Age.)

Figure 7: Lower House Members by Party and Age



Source: Japanese Politicians.com

The rise of young lawmakers can provide the impetus to reform the political system, making it more responsive to the Japanese public and to the needs of a changing Japan. Already, a gradual infusion of new faces bodes an eventual change in Japan's political culture. Several of the younger Diet members have graduate degrees in policy or have overseas educational experience, which might foreshadow a future trend toward politicians with more policy-making skills and less of a tendency to be beholden to the status quo. These new political actors are beginning to reach across factions and even party lines to work together. In July 2002, a group of 10 junior LDP and DPJ Diet members formed a study group to examine political activities related to funds and petitions, with an eye to increasing the transparency of political financing and the government's responsiveness to its citizens.

The importance of young politicians should not be broadly overstated, however. Still few in number relative to most members of a political party, many of them belong to opposition parties, which minimizes their effect on government policy today. As for younger, reform-minded politicians within the LDP, they are hampered by the old guard in several ways.

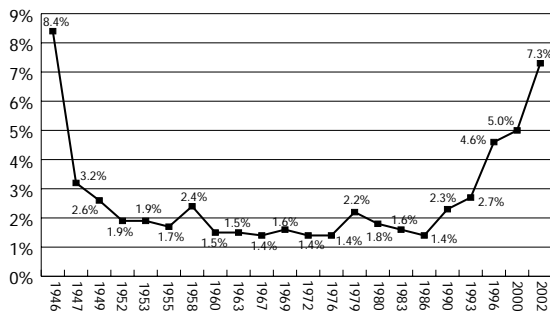
First and foremost, legislators wishing to submit legislation to the Diet must get the seal of approval from the LDP General Council and the Policy Affairs Research Council, which are controlled by the party establishment.

Second, more than half of the new political generation is a product of Japan's elite universities (Tokyo, Kyoto, Keio, Waseda, Sophia), which have traditionally produced the country's leaders. The trend of "dynastic politics" (the practice of family members "inheriting" a Diet seat) also continues. A candidate such as Yuko Obuchi, daughter of the late former Prime Minister Keizo Obuchi, not only has name recognition but can also inherit the *jiban* and *kaban* built up by her father. A support base and a fundraising apparatus can also be passed along to a loyal staffer, who can then run as a candidate on his or her own and keep the seat in the political "family."

Third, reform-minded politicians also would have to impose a higher degree of political direction and accountability on a bureaucracy that remains home to powerful career officials who hardly have an appetite for shattering the status quo. Although the bureaucracy has lost public respect, not to mention some self-confidence, as a result of its recent lackluster performance and recurrent association with scandals, competent and self-confident political leaders have yet to fill the vacuum created by this erosion of bureaucratic assertiveness. The balance of power between politicians and bureaucrats will have to change much more before the structural problems of the country can be fully tackled.

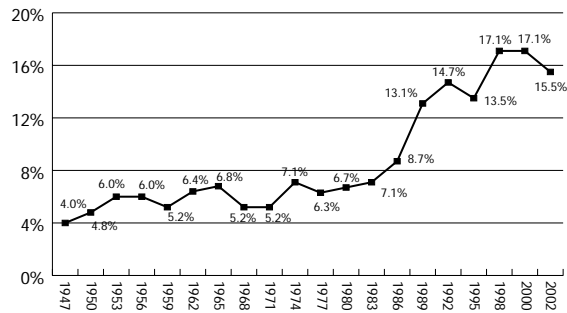
Women, likewise, have achieved some recent political successes — winning the governorships in Osaka and later in Chiba (an urban and suburban prefecture that includes Tokyo's international airport) — and account for more than 10 percent of Diet members for the first time since the immediate postwar era. Still, they remain minor players on the national political stage. (See Figures 8A and 8B: Percentage of Women in House of Representatives/Councillors.) Moreover, the exclusive old-boy network of senior politicians, bureaucrats, and industry leaders often keeps female politicians at arm's length. Outside of those from famous political families, many women candidates lack the *kanban*, *jiban*, and *kaban* needed to win a district election. Nevertheless, the electoral reforms of the mid-1990s, which introduced proportional representation, have helped the fortunes of women candidates. For example, 22 out of the 35 women members of the Lower House obtained their seats from party lists rather than from individual district victories — not a situation that encourages dissent from the party line.

Figure 8A: Percentage of Women in House of Representatives



Source: Prime Minister's Office, Annual Report on the State of the Formation of a Gender-Equal Society, Japanese Politicians.com

Figure 8B: Percentage of Women in House Councillors



Source: Prime Minister's Office, Annual Report on the State of the Formation of a Gender-Equal Society, Japanese Politicians.com

With the government becoming increasingly ineffectual — unable to build the kind of consensus that formed around postwar economic reconstruction or catching up with the developed West — Japan has witnessed the rise of new political players, especially NGOs, or NPOs (non-profit organizations) as they are more often labeled in Japan. A 1998 law has widened the scope for NPO operations, helping pave the way for these “civil society,” or citizen, groups, often led by a new generation of activists, to become increasingly important drivers of change.

The boom in citizen groups was spurred by a natural disaster, the Kobe earthquake of January 1995. Although the media perhaps overstated the government's ineptness in handling the disaster, the earthquake nonetheless showed that Japan had become too complicated to be managed by government alone. Half of Japan's 6,000 NPOs were founded in the years since the earthquake.

To be sure, NPOs are growing from a small start of what were earlier called “Article 34 organizations” (from Article 34 of the prewar Meiji civil code). Those organizations had to be linked to ministries — most often, the Ministry of Education — which then had license to send ministry retirees to the organizations. The legacy of Article 34 organizations hangs on — the word for such an organization, *zaidan*, conjuring a negative image for many Japanese.

Moreover, in a country with a weak tradition of private philanthropy, funding is a problem. NPOs that turn to the government risk being co-opted. Securing the benefit of being tax deductible remains complicated, and the process has to be renewed every two years. The idea of operating foundations, such as the Japan Center for International Exchange, a policy research center and clearinghouse for international-cooperation efforts, as opposed to grant-making foundations, remains unusual. Attracting and retaining professional staff is difficult, given the uncertain longevity and funding of new NPOs. Yet, Japan is in great need of more think tanks and organizations involved in public education and local issues — precisely what NPOs do best.

The emergence of Peace Winds, a humanitarian-assistance NPO, is illustrative. In a few short years, Peace Winds has built a \$10-million annual budget and a Tokyo staff of more than 40, and has placed 200 people in Kurdish northern Iraq alone. Its 35-year-old leader, Kensuke Onishi, has become a celebrity. His celebrity gained more currency when Peace Winds stared down a political baron, Muneo Suzuki, longtime leader of the LDP International Affairs Committee, which maintains strong ties to the Ministry of Foreign Affairs. When Peace Winds sought to be included in the international conference on reconstruction in Afghanistan held in Tokyo in January 2002, Suzuki resisted, apparently seeing Peace Winds as a challenge to his domination of policy toward overseas assistance. He lost the confrontation and was discredited in the process.

“Generational change is producing a less anti-military Japan and a Japan that is more independent and more open to international involvement.”

Peace Winds is at the center of the organization of a wider public-private aid enterprise, Japan Network, in which kindred NPOs would work directly with ministries in framing policy and managing assistance. One benefit to the government of such an organization would be more international visibility for Japan. Japan Network also would work with private corporations and other funding sources, such as Keidanren, the lobbying group for big business.

Worldview: Increasing Assertiveness

Without question, generational change is having a profound effect on the way Japan views its place in the world. It is producing a less anti-military Japan and a Japan that is more independent and more open to international involvement. This is a stunning reversal from the past half-century, in which Japan focused on postwar economic reconstruction while leaving national security thinking largely to the United States. Tokyo got used to *not* thinking about military strategy. Even when Tokyo adopted an independent approach, exemplified by its pro-Arab stance after the 1973 oil embargo, it did so only in reaction to a perceived American neglect of Japanese security interests.

Now, many of the underpinnings of a policy of compliance, and complacency, have been undercut. Japan is rich, not poor. The horror of World War II has receded, as have anti-military sentiments. This trend was reinforced during the 1991 Gulf War, when Japan could make only financial contributions because of its constitutional ban on the use of force abroad and was upset by the skimpy thanks it received from allies. This situation almost guaranteed that Tokyo would send at least token naval forces to the Indian Ocean in the current U.S.-led fight against terrorism and compelled additional voices to talk of revising the constitution. It is telling that more than 90 percent of politicians under age 40 favor at least some kind of revision.

Many Japanese are ready for their country to take the next step and allow its forces to operate in areas of conflict under U.N. authorization. The step after that would be to recognize that Japan, too, has the right to participate in collective self-defense, although such a development is unlikely in the near future. One recent sign of fading anti-militarism was the recent sinking of a suspected North Korean spy ship by Japanese forces. The sinking provoked no domestic outcry, despite being the first instance of Japan's military firing on a ship outside its territorial waters since World War II.

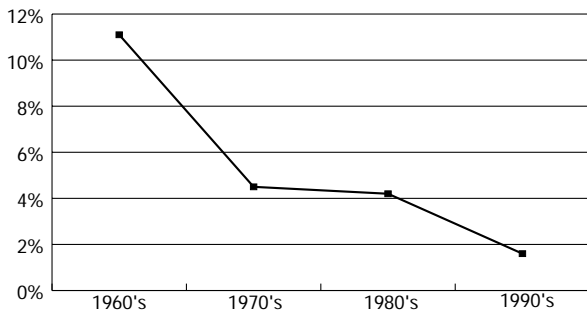
Other factors compel Japan to think increasingly in terms of a national interest that is perceived to be diverging from the interests of its long-time ally, the United States. China and even Korea are catching up economically and in military might. Japanese companies have millions of employees around the globe. And, most importantly, there is growing questioning of whether change is needed to the alliance with the United States, particularly now that the perceived risk of foreign invasion is less today than during the Cold War.

V. RESHAPING THE U.S. CONNECTION

Changes at home in Japan, coupled with those in Japan's geopolitical environment, will drive shifts in Japan's connections to the United States. Security issues and, more broadly, strategic considerations are likely to weigh more heavily in the relationship over the next decade than they have in the past half-century. Indeed, this shift is already visible, in marked contrast to the dominance of economics and trade concerns early in the 1990s. In a sense, the bilateral relationship is set to come full circle from the early postwar years, when security issues were very much at the top of the agenda. But, unlike the security dialogue of the Cold War period, Japan and the United States face a more diverse and less unifying set of strategic challenges. The potential for divergence of views is correspondingly greater, and long-standing assumptions about Japanese security cooperation must be examined.

The shift from economics to security as a source of U.S.-Japan friction has several sources. On the economics front, many of the most contentious trade issues are now behind, and the threat perceived by Americans of Japan as Number One has faded, along with Japan's economic growth rates. (See Figure 9: Real GDP Growth Rate.) This

Figure 9: Real GDP Growth Rate



Source: Economic and Social Research Institute, Cabinet Office National Accounts

is not to say, of course, that difficulties will not resurface: Japan's emphasis on developing Asian-only trade groups could fuel friction in its economic ties with the United States if such groups generate real momentum. It also is instructive that trans-Atlantic economic disputes with Europeans come and go. And it is true that big differences in economic structure between Japan and the United States remain. Still, the outlook is almost certainly continued, if slow, convergence. The financial systems of the two countries are also increasingly integrated.

At the same time, real debate on the security relationship is just beginning. At one level, the weakening of anti-military sentiment in Japan encourages a greater role for Japan in international security - precisely what successive American administrations have wanted. Prime Minister Koizumi's dispatch of naval forces to the Indian Ocean in support of U.S. operations in Afghanistan marked the first time Japan's armed forces have been deployed abroad to participate in an active conflict since the end of World War II. Japan also provided refueling for British units deployed to the region.

Koizumi's decisive action must still be regarded as exceptional, even path-breaking. It is not necessarily a guide to Japan's evolving security posture, despite Washington's desire to balance the alliance by upgrading Japan's military capabilities and lowering the bars to intervention abroad. Continuing economic malaise would limit Japan's ability to pay for military modernization of the type that would strengthen its potential as a security partner. In this context, the United States, which not long ago feared the strength of the Japanese economy, is now concerned by its weakness. Certainly, the likelihood is negligible that in the near term to medium term Japan will match Britain as an ally that often offers quick, strong support for the United States in security policy matters. Uncertainties regarding Japan's crisis management and

“The shift from economics to security as a source of U.S.-Japan friction has several sources.”

decisionmaking capacity are part of this equation; more-frequent discussions of Japanese national interest are another.

Even if Japan moves toward a more capable military posture, with more potential for power projection and participation in multinational operations, it is unclear that Japanese perspectives on security will remain fully convergent with those of the United States. A more capable and assertive Japan is also more likely to take its own foreign and security policy interests more seriously, with greater attention to matters of national sovereignty.

Japan is already eyeing changes to the security relationship. In particular, it is questioning the reliability of the United States as an ally on such issues as engaging North Korea and the political irritant of having U.S. military forces stationed in Japan, even if the distant southern island of Okinawa is home to most of the U.S. military presence on Japanese soil.^x (See Table 2: U.S. Military Presence in Okinawa and Japan.) Some Japanese who perceive a decline in direct military threats to their

homeland in the post-Cold War world feel that they can now afford to worry more about U.S. unilateralism, particularly when policies such as the rejection of the Kyoto protocol on global warming and the demise of the Comprehensive Test Ban Treaty are seen as running counter to Japan's best interests. This perception is at least premature, given the possibility of a more aggressive China.

Table 2: U.S. Military Presence in Okinawa and Japan

Number of Facilities			Land Area of Bases (1000s of m ²)			Number of Personnel		
Okinawa	All Japan	%	Okinawa	All Japan	%	Okinawa	All Japan	%
38	133	28.6%	237,527	1,010,124	23.5%	24,587	39,691	61.9%

Sources: Okinawan Prefectural Government; U.S. Department of Defense, *Defense Almanac*

In fact, there is nothing new about differences between Japan and the United States over security issues. Such differences have arisen from Japan's leftist opposition to U.S. policy in the 1960s, frictions over oil and strategy in the 1970s, and even with regard to Japan's financial contributions to the Gulf War in 1991. But, rightly, they all were overshadowed by economics and the reality of the need for the security alliance. In the future, Japan and the United States will have to work harder to manage security differences and reconcile some differing policy perspectives.

Part of that process will be for Americans to talk with a wider group of Japanese on security matters, and not just with traditional interlocutors such as the Foreign Ministry, which is traditionally reluctant to expose security issues to public scrutiny. And the United States will have to recognize that Japan will want a real role in shaping policy on key strategic questions, including the future of the Korean peninsula, missile defense, international terrorism, energy security, and, above all, the rise of China.

VI. THE RISE OF CHINA AND JAPAN'S ROLE IN ASIA

Any discussion of Japan's future, including its strategic relationship with the United States, invariably turns to the question of the rise of China and the implications of that rise for the world, for the region, and, specifically, for Japan's stagnation relative to China. In no small part, Japanese concern arises from the extensive attention the United States gave to Beijing during the 1990s, to the neglect of Japan.

During the 1990s, China's red-hot economy offered a stark contrast to Japan's constant flirtation with recession. China's Communist Party leaders moved away from a moribund command economy while embracing a growing role for market forces in the domestic economy — in the process, unleashing the prodigious entrepreneurial talents of its population. The nation opened its doors to foreign investment, which poured in by the tens of billions of dollars annually — much of it from Japan. Overseas companies, led by those from Hong Kong, Taiwan, and other ethnic-Chinese enclaves, took advantage of China's inexpensive labor and set up factories to make products for export to the rest of the world. With China's recent entry into the World Trade Organization (WTO), foreign businessmen have shown a growing interest in the domestic market of the world's most populous nation.

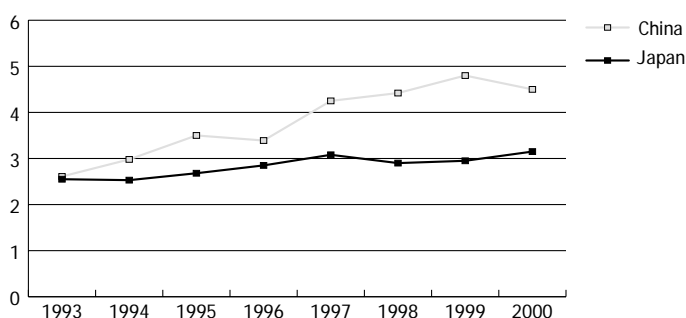
By almost any measure, China is a growing economic rival to Japan. Its demand for Intel chips, for example, will soon surpass Japan's; in five years, China will be the biggest market for personal computers in the Asia-Pacific region. By one estimate of purchasing-power parity, China's GDP outstripped Japan's, \$5 trillion to \$3.4 trillion in 2001. (See Figure 10: Purchasing Power Parity for GDP.)

China's rise is causing great concern in Japan, where anti-Chinese sentiment spread like a wildfire in the late 1990s, when Chinese-made goods, including counterfeits of Japanese, American, and European name-brand products, began putting pressure on Japanese goods in world markets. According to one analysis of U.S. imports, direct competition between products made in China and Japan has grown rapidly from barely anything in 1990.

One sign of strain was Japan's decision in April 2001 to erect barriers to imports of Chinese leeks, shiitake mushrooms, and tatami straw. Although the retaliatory trade dispute was resolved nine months later,^{xi} the underlying issue — how Japan will hold its own as China rises — remains unresolved. New strains on the political relationship came the following year, when five North Korean asylum-seekers were forcibly abducted by Chinese authorities from a Japanese consulate in China, creating an outcry in Japan about the violation of diplomatic sovereignty. The Japanese media adds fuel to the fire with critical reporting, including allegations — some quite credible — that China diverts for military purposes some of the substantial official development assistance Tokyo continues to provide each year.

“By almost any measure, China is a growing economic rival to Japan.”

Figure 10: Purchasing Power Parity for GDP
(Trillions of dollars)



Source: CIA World Factbook
Compiled by: National Bureau of Asian Research

Serious conflict between Japan and China is not inevitable. China has powerful reasons for keeping the strategic competition within bounds, including a desire not to interrupt the modernization of its economy and an interest in promoting a positive image in the run-up to the 2008 Summer Olympics in Beijing. On the Japanese side, Prime Minister Koizumi himself has tried to put a positive spin on relations with China, telling business leaders in spring 2002 that China's economic development presents an opportunity to nurture new industries in Japan.^{xii} China also offers opportunities for Japanese multinationals looking for new markets. Honda is already active in China, and the other Japanese auto companies are moving in to grab a piece of a market that is expected to reach 4 million cars per year by 2010.

While troubling from the point of view of strategic competition, China's rise might also present opportunities for Japan to reassert regional leadership. Concern over China is palpable around the region, deepened in many places because of the historic economic dominance of ethnic Chinese minorities. In this sense, both Japan and China face obstacles of history and perception in their regional relationships. Nonetheless, many Asians acknowledge the central role played by Japanese direct investment and overseas aid in developing their own economies in recent decades, and would like to see more Japanese engagement in the region as a counterweight to Chinese influence.

Yet, Japan faces several obstacles to increased regional leadership. First, economic troubles at home make it unlikely that Japan can be as great an engine of growth for the rest of the region as it was in the 1980s and early 1990s. To the disappointment of its neighbors, Japan is still not very open to foreign products and investment, although recent change is making it more so. China, meanwhile, moved quickly to begin negotiating a free-trade arrangement with ASEAN. Tokyo opted to start on an agreement limited to Singapore, only later proposing an agreement with Southeast Asia.

Despite many possible points of convergence on economic and security fronts, Japan's relations in East Asia remain hobbled by the historical legacy of World War II and by the sense across the region that Tokyo continues to avoid a frank reappraisal of its role in that conflict. The controversy over the treatment of the wartime period, including Japanese atrocities, in the country's textbooks is a leading facet of this ongoing dispute, especially for South Korea but for China as well. With American policymakers looking to Japan to play a more active role in regional security and development, Japan's ambivalent relations with East Asia may ultimately prove a limiting factor.

These problems aside, there is broad recognition that Japan needs to work with the United States — and with other Asian states — to develop a shared response to the rise of China. On the economic front, both the United States and Japan have an interest in promoting market discipline, which they hope to accomplish through China's recent entry into the WTO. Beyond trade and investment, Japan and the United States clearly have a shared stake in the stable evolution of China toward a more democratic model. In security terms, regardless of the evolution of Chinese regional policy, dealing with a more powerful China is likely to be a constant factor of the security calculus of both Japan and the United States over the next decade. The quality of Japan-U.S. cooperation in this regard will also tend to shape the outlook for bilateral cooperation on security matters in general — a facet of the relationship that will trump economic and trade concerns in the coming years.

VII. SHOCK THERAPY: ALTERNATIVE SCENARIOS

This report paints a picture of a Japan in which drivers of change — from foreign investment and demographic shifts to a new generation of leaders — are likely to steadily undermine the economic and political practices that led first to Japan's great success and, more recently, to its long stagnation. Some of these drivers will also bring fundamental change to the U.S.-Japan relationship, for which the key issues — and tensions — for the medium term are likely to continue to be in military security rather than in economics and trade. At the same time, the rise of China is putting additional pressure on corporate Japan, and Japanese diplomacy, and challenging the geopolitical status quo in Asia.

Much of the change envisioned above is gradual, even evolutionary. But it would be a mistake not to explore the prospects of an internal or external shock to Japan that might bring about change at a much more rapid pace — either an accelerated revitalization or, less likely but still possible, an accelerated decline. Such shocks have jolted Japan into action before. The most famous example is the arrival of U.S. Commodore Matthew Perry's black ships in 1854, which opened an inward-looking Japan to trade and triggered rapid modernization, quickly transforming the country into a world power.

One often-discussed scenario for a domestic shock goes as follows: A strong yen locks Japan more tightly into its deflationary spiral and hastens the move of manufacturing offshore, taking jobs with it; at home, the NPL problem continues to threaten banks and firms. The comfortable stagnation that marked the past decade — one in which the vast majority of Japanese have kept their jobs and their quality of life — will become far less comfortable for many, and less sustainable as a result of rising government debt. In this climate, a mid-level bank failure leading to the bankruptcy of several firms the bank had supported sets off a financial panic (although individual savings likely would be protected through existing deposit insurance). That failure might then galvanize Japan's emerging younger politicians to demand action, not only to fix the problems of the financial sector but also to move more rapidly with the overall restructuring of the economy, thereby averting further bankruptcies and ever-rising unemployment. The possibility of bank failure is far from fanciful. Note that, in 2002, international ratings agencies downgraded Japan's credit by two notches while upgrading Korea's by two.

A turnaround could occur quickly, partly because considerable change has already taken place at the micro level and because the widespread understanding is that Japan's economic situation has deteriorated significantly in recent years. Such a crisis may give the government a mandate to act, although precisely how a new reform-minded leadership would come to the fore, a leadership in which senior ministers of government would hold real power instead of being manipulated by party barons acting behind the scenes, is still the question.

Japan's political parties appear to be converging, most notably in foreign policy, where the anti-military "left" is all but eclipsed. And they are converging on domestic matters as well, especially among younger politicians. Exactly what a reshuffled deck of political parties might look like is, in the nature of things, hard to foresee. One possibility would be two parties in broad agreement on the shape of the economic system, neither one of them anti-capitalist or anti-business, and in that sense not so different from Republicans and Democrats in the United States. The two would, of course, have their own constituencies and so their special interests — perhaps one tempered in its reformist efforts by union support and the other seeking to hold onto aspects of the status quo for rural dwellers or older workers. Another scenario would have a

“An internal crisis might provide the impetus to, first, undertake a serious economic restructuring, then, as the political frustrations of that process became plainer and plainer, to engage in a broad political reshuffling.”

committed reformist party, perhaps supported by multinational firms and disaffected urban voters, successfully confronting a rump LDP, with the latter as a grudging and cautious partner in political and economic restructuring.

The key to that political reshuffling would be breaking the iron chains — the three bans — of money and party discipline, especially *kaban*. Or it could be having reformist politicians find a way to tap into new sources of money from the high-growth, productive sectors of the economy that have shunned deep political involvement so far. As it now stands, the risks to politicians of leaving the LDP especially are simply too great, so young reformers soldier on within the party, trading security for very little real political power. An internal crisis might provide the impetus to, first, undertake a serious economic restructuring, then, as the political frustrations of that process became plainer and plainer, to engage in a broad political reshuffling.

Looking to external shocks, it would take some watershed event or milestone for China to serve as the goad to Japanese restructuring, something comparable to the Soviet Union’s launch of *Sputnik* for the United States. China’s own burgeoning space program, which is believed to be close to placing an astronaut in orbit, might provide such a stimulus. More ominously, evidence of China’s aggressive military potential, such as a crisis over Taiwan that includes more missile tests or bullying of another neighbor with whom it has territorial disputes, might also provide such a stimulus. Japan can no more afford to ignore progressive strengthening of China’s nuclear and missile arsenal or of its general ability to project military power around the region, than it can afford to ignore a sudden, dramatic demonstration of Chinese power.

How might Japan respond to such external shocks? The most likely response would be an augmented strategic relationship with the United States, the only viable partner for the longer-term containment of China, and a more effective convener for a regional security response than Japan. Alternatively, Japan might respond by opting out and accepting second-tier status. Either way, Japan might logically consider nuclear defenses in some form as an equalizer or as ultimate insurance. However, such a consideration would require a sea change in current attitudes toward military security and the regional international order. On the whole, opening up and cooperating more closely on security matters with the United States and regional partners is a more likely path than opting out and unilateral responses. But the latter is not beyond the realm of possibility. Much will depend on the behavior of the United States.

It has been suggested that the United States might provide an external shock to the Japanese system. An abrupt U.S. decision to withdraw its forces would indeed dramatically change its security relationship with Japan. Such withdrawal is not in the cards: Far too much is at stake. However, a new Sino-U.S. confrontation (more serious than that over the collision between a U.S. spy plane with a Chinese fighter jet over the South China Sea in 2001) might prove a shock to Japan, convincing Tokyo that a close relationship with the United States brings more risk than reward, that the United States had become more lightning rod than umbrella as a security partner. That perception could certainly trigger Japanese debate over whether and how the country should organize itself for security and prosperity without, or with a much-reduced dependency on, the United States. While such a debate would surely reverberate through Japanese politics and the economy, it ultimately could result in detractors in either country realizing that the mutuality of interest is too strong for them to think that seeking to derail the alliance is plausible.

Other external shocks are imaginable as well, including developments on the Korean peninsula. Prime Minister Koizumi's September 2002 trip to North Korea — the first meeting ever of the Japanese and North Korean heads of government — appears as one dramatic example of Japan taking a more active role in addressing perceived threats independently. By repatriating the last of the Japanese terrorists it had been harboring, and now admitting to recent naval incursions into Japanese sea-lanes and to abducting a dozen Japanese citizens during the Cold War, North Korea looked to open the door for normalized relations with Japan and shift the geopolitical equation. The subsequent admission by North Korea that it was developing nuclear weapons in defiance of its previous agreement with the United States, Japan, and South Korea to abandon such programs in exchange for economic assistance has once again brought the North Korean issue to the forefront of international security concerns of Japan and the United States.

The unification of North Korea and South Korea would be a daunting challenge, creating a country that is poorer and more preoccupied internally than today's South Korea. It would limit Korea's ability to serve as an economic competitor to Japan in the medium term, but it would surely impose new demands on Japanese foreign policy overall.

While regional shocks could serve as agents of economic reform in Japan, they might also provoke heightened nationalist tendencies in Japan's policy at various levels. Some of this assertiveness might come in the context of a good working relationship with the United States and positive relations around Asia; some might not. Against a background of uncertain American policy, economic recovery and increased political assertiveness might well challenge the prevailing model of Japan-U.S. relations. In the absence of continued bilateral consensus on shared interests and policies, a more vigorous and engaged Japan might well turn out to be a less comfortable — and certainly a less predictable — partner for the United States.

The other, less likely, future for Japan is accelerated decline, which could result if the present domestic stagnation turned to stasis — comfortable enough for many Japanese, but not solving the problems piling up beneath the surface. This scenario envisions a Japan that continued to be beset by its familiar problems, both economic and political, although none of these problems sharp enough to upset the status quo. Or a major shock along the lines of those outlined above might hit the country but would not serve to snap Japan out of its systemic lethargy. Accelerated decline might result from a shock that did not provoke a decisive response but led, instead, to a cascade from crisis to crisis. Bank failure triggering runs and other failures, or major malfeasance and scandal in the postal savings or pension systems are among the possible crises that could accelerate decline, particularly if the political system remains stuck with a continuing revolving door of ineffective prime ministers.

Proponents of European integration used to liken the process of integration to riding a bicycle: Once the speed of forward motion dropped too low, the bicycle and its rider were in danger of falling over. In Japan, a similar premise may hold true: Just to sustain the macro-economy in a holding pattern requires a minimum set of economic and political reforms to stave off contraction. If neither drivers of change nor shocks to the system lead to a political consensus for reform, Japan runs a very real risk of falling into accelerated decline.

This gloomy prospect could produce unexpected twists in Japan's foreign and defense policy. If any country is a candidate for a real revolution in military affairs, it is Japan. Its military forces, although capable, have much less vested interest in existing weapons or operational routines than do other sophisticated militaries, including the U.S. military. Japan might decide

“Political and economic practices that seemed to serve the country well as it sought to catch up with the West no longer do so.”

to build a very capable small force as a deterrent, with standoff weapons based at home but capable of reaching areas of strategic interest. In principle, nuclear weapons could well be part of this equation, and economic constraints might actually argue for an emphasis on ultimate deterrence without the expense of large conventional forces. Given its technological and industrial base, Japan could almost certainly build such a force very quickly. The extremely negative political consequences of taking such a path, for Asia and perhaps more broadly, go without saying. And Japan’s own nuclear “allergy” would not be easy to overcome. Overall, for Japan to take that path is an unlikely excursion. Whether to take it has become part of Japan’s own security debate, and the final decision could be affected by the outlook for economic recovery or decline.

VIII. THE IMPLICATIONS OF A REEMERGING JAPAN

Because of the high stakes and great mutuality of interest politically and economically, Americans almost as much as Japanese must focus on Japan’s choice: Will Japan set a course of selective self-reform that leads to a future brighter than the past decade of stagnation?

A key feature of the Japanese situation is that political and economic practices that seemed to serve the country well as it sought to catch up with the West no longer do so. Such practices, however, continue to attract powerful supporters of the status quo. Such supporters strongly oppose, and will seek to obstruct and slow, the reforms needed for Japan to regain competitiveness in a global, market-driven economy.

It is hoped that Prime Minister Koizumi will prove to have the right stuff to bring change and to bring it soon. If not, a new generation of Japanese politicians inevitably must back the reforms necessary to make Japan more competitive, thereby providing crucial support for the drivers of change that have started reshaping the economy. Indeed, Japan already appears to be converging with the United States by gradually moving toward a more competitive, more open economic model. The best bet is that Japan eventually will be back on the world stage, as a vital economic force and as a more independent political force — although it will surely take time.

A foreign policy worthy of being described as “Japan’s way” hardly exists: The country has relied strongly on the United States as ally and protector since the end of World War II. Until now, Japan has traded some autonomy, and endured the lingering U.S. military presence on its southern island of Okinawa, for security. Behind an American defense umbrella, Japan has shunned military issues and, most important, become rich while spending very little on defense throughout much of the Cold War era.

The demise of the Soviet Union and the end of the Cold War mean that Japan no longer needs to fear attack by the Soviet Union or its proxies. It does not mean that for now the U.S. alliance is any less necessary as important insurance against highly uncertain future developments in a region of high tensions, above all those tensions arising from an economically stronger and more aggressive China.

Indeed, one of the dominant traditions in Japan’s diplomacy over the past century has been to accord priority to its relationship with the strongest Western country — first Britain, then

Germany, and now the United States. The United States has consolidated its power and that should help ameliorate the likelihood that Japan might drift away. It goes without saying that such problems as the number of U.S. troops in Okinawa still must be addressed, in large part because, inevitably, less tolerance is accorded a visible foreign military presence when immediate security threats are absent. However, this does not mean that the Japanese will not continue to put up with a substantial U.S. naval and air force presence on their main islands for some time to come.

IX. THE WAY FORWARD

- *The Japanese government must do much more to encourage the drivers of change that will make the economy more competitive — small- and medium-sized enterprises, corporate reform, women, immigrants, and foreign investors and employers.*

To shake off its economic malaise, Japan needs to create a hospitable environment in which these groups can succeed. Although doing so will require shifts in predominant national attitudes, this report points to some areas in which specific government action also would be helpful. To help SMEs, for example, the government needs to develop a tax system that positively encourages — and does not discourage — entrepreneurial activity and risk-taking. The government, which has long fostered major industry, needs to develop more-effective policies for nurturing SMEs. To bring more women into the workforce, the government needs to enforce existing anti-discrimination laws and bolster social services such as day care. Meanwhile, official barriers — and attitudes — to a dynamic foreign presence in Japan need to ease.

- *Japan needs a more open debate on the country's strategic relationship with the United States, and on its course in Asia and on the international scene.*

Much more so in Japan than in the United States, foreign policy and defense remain the province of officialdom. Only a few analysts outside of government are involved in policy matters, and they typically have close ties to the bureaucracy. A wider discussion is long overdue on Japan's strategic interests, its stakes in China, and the implications for a strategic relationship with the United States. One important by-product of a more diverse and more open foreign policy debate will be a wider range of interlocutors in relations with the United States and others — a requirement if Japan is to address a wider set of international challenges in a more complex strategic environment.

As this report clearly indicates, the Pacific Council welcomes the opportunity to provide a forum on both sides of the Pacific for discussions that can help achieve that better understanding.

- *Foreign companies can anticipate an increasingly attractive climate for investment, and for partnerships among private actors.*

Japan will become more than just a source of cheap assets. The salutary effect of foreign capital and management should lead to a greater openness toward inward investment. In the short term, foreign businesses, including American businesses, will be able to attract talented young Japanese, especially women, who continue to be overlooked by traditional Japanese companies. In the longer run, Americans and other foreigners will find attractive partners in Japan, whether for building global businesses or for developing an international network of NGOs. As Japan moves from building wireless devices to producing content, the idea of Japan as an Asian center of entertainment, fashion, and design is not far-fetched, and will provide new opportunities for investment from Hollywood and elsewhere.

- *U.S. responses to Japanese reform efforts should be constructive and cooperative, and urge nothing less than real structural reform.*

The United States has an obvious and entirely justified interest in an economically stronger Japan that will be more able and more credible as a U.S. ally on the international stage. Moreover, the United States has an obligation to its own economy, to other Asian economies, and, not least, to the Japanese people to press for reform that corrects those practices that pose a grave risk of undermining the substantial achievements that have made Japan the world's second-largest

economy. In pushing for reform that will reenergize the Japanese economy, it is important that the United States understand that a Japanese model of reform may legitimately seek to retain valued social traditions.

- ***Greater transparency in economic relations with Japan can prevent the acrimonious economic relations of the 1980s from reemerging.***

Trade frictions between the United States and Japan, which would have been central to discussion of a binational project a decade ago, have receded. Talk of economic competition is almost absent from this report, partly because progress has been made in resolving many of the thorniest issues that bedeviled economic relations in the 1980s and partly because others have been put on the backburner. In large part, it is even more the result of the reversal of fortunes between Japan and the United States in the 1990s: Japan's economy faltered while the technology-led U.S. economy zoomed forward. With the U.S. downturn at the beginning of the 21st century and uncertainty about the country's economic future, it is possible that bilateral trade relations could again come under pressure. Working out agreed-upon rules of the road should go a long way to help manage those relations. It will also help to avoid a situation in which looming frictions over security cooperation interact with trade frictions to cloud the overall bilateral relationship.

- ***Foreign policy and security policy cooperation will require serious and substantive consultations between Japan and the United States to determine what role both will play in their alliance.***

Much of the focus of those consultations will deal with how to respond to the rise of China, but they can also be expected to address other critical issues, such as Korean reunification, missile defense, energy security, and the global fight against terrorism. Japan and the United States will need to engage in active, joint policy planning on all such questions.

- ***Maintaining a U.S. military presence in Japan will best serve the stability of Northeast Asia until the intentions of Japan's neighbors are much more certain.***

Northeast Asia since the end of the Cold War remains a region of substantial tension and has the potential for hostilities. Given the uncertainty of intentions and the growing military capabilities of some of Japan's closest neighbors, it would be very unwise for Japan and the United States — and very destabilizing for the region and indeed for all of Asia — to alter their present security arrangement in a way that weakened its military capability or signaled an erosion of U.S. commitment to protect Japan. A continued presence of U.S. bases and troops — although not necessarily at today's level — is the most tangible and credible evidence of continuing U.S. commitment.

- ***The United States and Japan have a shared stake in renewed dynamism.***

In the long run, Japan and the United States will be bound by shared stakes and by common tasks more than by treaty provisions. The two will be economic competitors, but that competition is what drives the global economy and is a normal aspect of international relations. For the foreseeable future, Japan and the United States will have much to learn, and much to gain, from each other. A future Japan of restored dynamism would be an attractive economic partner — and much more. It could well be what it aspired to be before its doldrums and the Asian financial debacle — that is, an economic partner, a technological leader, and a powerful force for addressing problems in Asia and beyond. In short, Japan has the potential to be a more important, if less predictable, partner in a changing world.

INDIVIDUAL TASK FORCE MEMBER COMMENTS AND RESERVATIONS

Paul Crane Dorfman: “This report outlines a scenario in which a favorable outcome results from internal or external factors stirring the government of Japan and Japanese businesses into necessary action. Unfortunately, the record to date gives little sign for optimism in that regard. Perhaps this is a result of the fact that what is rational for a country may not be rational for its political leaders as individuals. Perhaps it is a result of particularly Japanese cultural factors having to do with dealing with bad news.

The report cites real reasons for optimism but overweights them compared to the forces which retard change in Japan. The revitalization of Japan which is envisioned is very dependent on three things which are not at all probable: (1) much greater freedom for market forces to work, (2) much more of a role for women and immigrants, and (3) a much more encouraging environment for new businesses to start and develop. Each of these would involve a fair amount of pain for the country and its current business and political leaders.

Obviously, I hope that I am overly pessimistic but what we have so far is a record of failure on these three matters with some encouraging signs. I hope that these are truly signs of a turning point rather than small cross currents which cannot resist the tide of tradition.

Part of the problem, of course, is that if corrective action is too gradual the very real problems which Japan faces will themselves eventually cause a crisis of great magnitude. A dispassionate observer only of macroeconomics might say that the crisis will itself goad the government into action. That may be, but the cost in human suffering in such a scenario will be much higher than it would need to be if action were taken now.”

Steve Clemons: “This valuable report sifts through the hype of Japan’s demise and identifies important and under-appreciated trends that point to a more politically and economically assertive Japan in the future.

However, given the ground-breaking material in this report on a new, assertive sort of Japanese nationalism, which may be less respectful of the old terms of U.S.-Japan relations, I do not think our section on defense and security goes far enough. Japan’s leading opposition leader, Yukio Hatoyama, as well as Japan’s last media-savvy reformist prime minister, Morihiro Hosokawa, have both proposed a future U.S.-Japan alliance without bases. Others who are less bold but still part of Japan’s conservative political aristocracy have argued for maintaining the general outline of U.S.-Japan security relations but with Japan playing a much greater role in the partnership and with sovereignty over the U.S. bases reverting to Japan. Despite the intransigence of both the Clinton and George W. Bush administrations on the subject of relocating U.S. marines from Okinawa to other sites, many in the Bush administration signed a study group report, the so-called “Armitage Report,” expressing the need for America to be flexible on the subject of this marine deployment. However, the report uncharacteristically neglects these trends and generally perpetuates a status quo understanding of U.S.-Japan security relations. In my judgement, the likely serious frictions between Japan and the United States on security issues are not adequately confronted.”

Brad Glosserman: While I endorse most of the conclusions in the task force report, I take exception to a few important ones. First, I am not so sure that the drivers of change described in the report will ultimately prevail to get Japan back on track. For understandable reasons — a risk-averse outlook, vested interests, and the “painlessness” of today’s stagnation — the Japanese could choose the status quo and shy away from the wrenching adjustment that is needed. In my view, incrementalism is not a viable option given the scale of economic restructuring required to make Japanese corporate assets productive again. But I do not sense a Japanese commitment to wholesale change.

My second dissent concerns constitutional revision. While some change is very likely, I am not sure that Article 9, which renounces war, will disappear. Many Japanese believe that the renunciation of war is their singular contribution to international relations and should not be abandoned. Thus, constitutional revision is likely to focus on the right of collective self-defense.

That ties into another conclusion with which I take issue: I believe that the United States might act abruptly to end the alliance with Japan if Americans feel Japan is not sufficiently responsive in time of crisis. The U.S. failure to manage the relationship well — for example by running roughshod over Japanese opinion on important issues — could inspire Japanese to conclude there is little point to being a good ally, which would in turn give a U.S. government reason to turn its back on the alliance.

Robert Sharp: This report covers Japan’s current situation quite thoroughly, and avoids many of the common cliches. I detect a bit of a tendency to assume that Japan will follow the U.S. model, or should, while I would emphasize that Japan will find its own way and its own solutions.

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- xii David Kruger, "Reinventing Japan: Sino-Japanese Trade Tension Likely to Grow," *Far Eastern Economic Review*, April 25, 2002, p. 30.

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