Japan: A Rising Sun?

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The Third Way and Prosperity

As Japan enters the twenty-first century, it sits on the brink of the biggest transformation in its history. Some observers want to write off Japan as stuck in a cycle of debt and deflation, but today's structural reforms in the Japanese financial system are quietly setting the stage for an economic revolution. Although rebuilding the Japanese economy will be no easier now than it was during the Meiji Restoration or after World War II, the present changes are more fundamental than anything the country has ever seen. Japan's revolutionary path will utterly transform it from the state-run industrial powerhouse of the twentieth century toward an innovation-driven, globalized economy of the twenty-first.

This transformation, however, is not necessarily synonymous with economic recovery. In fact, an overhaul of this magnitude is likely to shrink the economy as Japan initially encounters higher unemployment, lower capital investment, and other deflationary problems. But these downturns are temporary. Japan's financial sector is being reformed—forcibly changing the way companies do business. As it develops, this new financial system is sowing the seeds for an entirely new Japanese economy—one driven by innovation and competition among small and medium-sized enterprises and high-tech companies. The old economic guard of Japan still receives most of the world's attention. But the real action is taking place in

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the smaller, newer, more creative enterprises that will bring twenty-first-century prosperity to Japan.

THE EMPEROR’S LAST STAND

The spark that ignited Japan’s economic revolution was cast by the collapse of the nation’s financial system in the late 1990s. Until that collapse, Japan preferred that the government have nearly total control of the economy. While other modern democracies relied on free-market competition to distribute capital, Japan spent the last century perfecting a financial system that allocated capital according to government criteria. In fact, the recent affinity for state-directed economic policies began much earlier. When Japan isolated itself from the rest of the world during the Tokugawa era (1603–1867), the shogunate tightly controlled all domestic activity, from transportation to commerce.

Unsurprisingly, when a few outlying samurai families decided to replace the Tokugawa shogunate with Emperor Meiji and begin crafting Japan’s first modern economic system in 1868, they continued to emphasize the state’s control of capital. The self-appointed reformers who shaped the Meiji government wanted a modern economy that could support industrial growth at a pace necessary to catch up with Western countries. To achieve such rapid-fire industrialization, the Japanese government—rather than individuals—took the risks and footed the bills. Some of the wealthy merchants who had made their fortunes during the Tokugawa period led and partially funded the new enterprises, but they worked in tandem with the state, not as independent entrepreneurs. Most merchants became political actors collaborating with the central government, and many started the government-supported, family-run companies and banking houses (zaibatsu) that fueled much of Japan’s growth in the first half of the twentieth century.

Japan steadfastly resisted a short-lived effort by the postwar American occupation forces to introduce competition-based capital markets in the late 1940s. As a result, its economy in the 1950s looked very much like it had in the 1930s, with the state, appointed banks, and large companies working together. The government soon established several
financial institutions to apportion capital to companies and sectors it deemed important for economic recovery. The government–run banks included a long-term credit bank, an export-import bank, a development bank, a bank for small-business financing, a foreign-exchange bank, and even a bank for long-term lending to agriculture, forestry, and fishery ventures. The government used this network of banks to make Japan globally competitive by promoting specific industries such as steel, auto manufacturing, and consumer electronics for export. It also used the banks to subsidize small rice farmers and domestic food processors, protecting them from international competition. Eventually, economic growth became managed almost entirely by bureaucrats.

As a result, private funding sources did not develop, in turn making it nearly impossible for new companies (whether foreign or domestic) to enter the marketplace. Being listed on the Tokyo Stock Exchange (TSE) was practically impossible for any company that did not have 25 to 35 years of proven profits. And initial public offerings rarely occurred. Individuals who took the risk of raising capital but failed never got a second chance.

State-controlled competition was further complemented by another postwar development in the Japanese industrial structure. The keiretsu or “enterprise group” system was a new concept that resembled the family-run zaibatsu of prewar days. The keiretsu linked several companies from each major industrial sector, all funded by a main bank. The relationships between these companies were cemented through a shareholding system that allowed keiretsu members, primarily main banks, to hold up to 60 percent of each other’s shares to prevent outside takeovers. The keiretsu groups often locked suppliers and distributors into exclusive relationships to ensure a smooth and dependable distribution chain. Over time, these relationships overshadowed other factors such as efficiency, price, and product. Thanks to the keiretsu structure, large, family-owned companies like Mitsubishi, Sumitomo, and Mitsui became as prominent in the postwar economy as they had been before.

The key to the keiretsu structure was the main bank. A main bank allocated capital among its keiretsu’s companies based on both government industrial policy and the priorities of the group. The main banks had the duty of distributing cash, policing investments, and
overseeing the industrial development of their groups by deciding who would get capital and when. The lack of true equity and capital markets only enhanced the status of the main banks and further entwined Japan’s industrial and financial sectors.

The system of market manipulation—rather than market competition—worked after the war just as it had in the Meiji (1868–1912) and Taisho (1912–26) eras to propel Japan into prosperity and global standing. Once Japan achieved its postwar goals, however, the keiretsu method of indirect financing began to unravel. Banks and businesses committed themselves to unnecessary expansion and unsustainable projects. Companies began to invest in ventures outside their core business areas, and their main banks granted unwise loans based on relationships rather than economic viability or detailed business plans. Within a decade, excess capital became excess capacity.

In the late 1980s, Japan’s bubble economy, inflated by exorbitant real estate values, collapsed. Soon after, companies found they could not repay their loans due to failed investments and a deteriorated
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economy. Nor could banks demand that their loans—many of which had been secured with insufficient collateral, primarily overvalued real estate—be repaid. At first, many banks attempted to hide these bad loans. But after a few years, some of Japan’s biggest financial institutions found themselves on the verge of collapse. In November 1997, Sanyo Securities, Hokkaido Takushoku Bank, and Yamaichi Securities all closed their doors, sending the country into shock.

THE BIG BANG

The government’s inability to rescue Sanyo, Hokkaido, and Yamaichi brought Japan to the stark realization that its financial system had failed. Fortunately, the failure came right after Prime Minister Ryutaro Hashimoto and his cabinet announced the 1996 “Big Bang” initiative to liberalize the Japanese financial system. The coincidence breathed new life into what would otherwise have been token financial-sector reform. Somewhat inadvertently, and certainly contrary to the expectations of the government officials who crafted the Big Bang, these reforms provided the makings of a revolution.

Hashimoto’s initiative got its name from the Big Bang launched under Prime Minister Margaret Thatcher in the 1980s to reform the British economy. Implemented in 1998, Japan’s Big Bang was intended to make the financial system more transparent and accessible by loosening the insurance and securities sectors, providing tax cuts for corporations, and restricting the regulatory power of the Ministry of Finance by establishing the Financial Reconstruction Commission, the Financial Supervisory Agency, and an independent Bank of Japan. Despite some backsliding, the improved market access and reconfigured financial regulatory bodies created by the Big Bang have allowed new entrants into the marketplace to challenge the former giants.

Ironically, the Big Bang also gained strength from the economy’s refusal to recover. As the Japanese economy steadily tightened, it created additional pressure on the banking sector to open up to competition and consolidation. For example, the bad loans on the books of many banking and securities institutions resulted in a profound scarcity of capital. In response, the Japanese government stepped in to prop up a few banks with large infusions of cash and began letting banks write
off bad loans in the spring of 1998. Other financial institutions, however,
such as the Long-Term Credit Bank of Japan and Yamaichi Securities,
were less lucky and had no choice but to seek foreign capital to survive.
And with main banks reluctant to lend to their related companies
within the keiretsu system for fear that the loans would not be repaid,
some Japanese companies, too, had to ask foreign investors to come
to their rescue. The resulting flow of foreign direct investment (FDI)
has yet to slow.

Although still low in comparison with FDI in other countries, the
amount of foreign investment in Japan has increased more than 100
percent since 1997. In 1998, Japan had 1,542 cases of FDI, with a total
value of $10.5 billion. The 727 foreign investments made in the first half of 1999 alone—
totaling $11.3 billion—exceeded the entire total for 1998. American companies accounted
for 60 percent of Japan’s FDI in the 1998 fiscal year; European companies accounted for
most of the FDI into Japan in the first half of the following fiscal year.
Foreign investment shows no signs of abating, especially since many
in the foreign community believe the current climate for doing
business in Japan is the best it has ever been.

Accompanying the new influx of FDI are other opportunities for
creative new Japanese companies to access capital. To support small
and medium-sized non-keiretsu enterprises that had always faced
limited access to capital, Japan created a new market last year. It plans
to inaugurate another one this summer, this time springing from the
Japanese entrepreneur Masayoshi Son’s plan to create a NASDAQ Japan
for relatively young, unproven companies to raise capital through
public offerings—threatening the dominance of the TSE. In response,
the TSE rushed to preempt Son’s efforts by opening MOTHERS—Market
of the High-Growth and Emerging Stocks—in December 1999. In
less than a year, the time it took a company to “go public” in Japan
dropped from 30 years to a month. Boasting 7 listings, with 20 more
in the wings, the new MOTHERS emphasizes transparency over past
performance and eases the demanding criteria that the TSE uses for
listing stocks on its main board. NASDAQ Japan, meanwhile, has three
times as many applicants as it expects to list once it opens. Although
the price of each of the newly listed stocks has declined since the recent technology stock crash, one by as much as 90 percent, initial public offerings are still flooding the marketplace. And thanks to Japan's new financial liberalizations, investment banks from abroad can underwrite many of these projects.

Under the Big Bang reforms, foreign investment banks can also participate in the mutual fund and retail banking sectors by taking advantage of new possibilities in personal savings. Last year, the Japanese government passed a law establishing U.S.-style 401(k) retirement plans for employees. This defined-contribution plan differs from the defined-benefit plan that Japanese employers have always provided. For the first time employees will help invest their own retirement funds. Moreover, these changes come at the same time that many individuals' ten-year deposits in the Postal Savings System—a quasi bank run by the government—are maturing. The Postal Savings System has begun paying out some of its approximately $980 billion in matured deposits to individual investors. Although initial statistics show that as much as 96 percent of the payouts has been reinvested in the Postal Savings System, almost half of the money has been put into short-term accounts until better long-term investments are found. Even if most of the payouts remain in the system, investment analysts expect that Japan's low interest rates, along with the government's eventual reduction of insurance limits on bank deposits, will still encourage some to put their savings in equities.

Many large U.S. investment firms, such as Goldman Sachs, Merrill Lynch, and Fidelity, are hoping to take advantage of these new opportunities by persuading the average Japanese family to deposit its bundle of savings with their money managers. In addition to using advertising and free training seminars to educate investors, most foreign firms have teamed up with Japanese partners to help make investors more comfortable doing business. For example, Merrill Lynch hopes to make the troubled retail facilities it gained in buying part of the failed Yamaichi Securities profitable by offering American-style investment services to Japanese consumers. Putnam has formed alliances with Japanese entities, and Salomon Smith Barney has created a wholesale banking venture with Nikko Securities. Fidelity had initially planned to sell its products alone, but it recently partnered with the
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Bank of Tokyo-Mitsubishi and the Nomura-Sumitomo brokerage consortia to market its funds to Japanese consumers. If these consumers achieve greater returns on their retirement investments, the increased dividends will relieve the pressure on Japanese families to save so much. Consumer spending could go up, spurring a demand-led growth that would help pull Japan out of the economic doldrums.

EYES ON THE BOTTOM LINE

The changes in Japan’s financial sector are all the more revolutionary because they have begun to spill over into the industrial structure of the economy. The influx of FDI has done more than just give capital to needy Japanese banks and companies. Foreign investors are bringing technical expertise and know-how to current restructuring efforts all over Japan. Japanese companies have begun seeking out their own consolidations and mergers in order to receive the same opportunities that foreign investors have seized. They are voluntarily restructuring themselves and sloughing off extraneous investments, focusing instead on the most profitable areas of their business. Motivated by the rising cost of capital, universally low profits, growing global competition, and the information revolution, many Japanese companies have now set their eyes on the bottom line.

By putting profits above personal and business loyalties, companies are even crossing keiretsu lines. The most publicized and prominent such deals are the Sumitomo-Sakura bank merger and the newly christened Mizuho Bank, made up of Dai-ichi Kangyo Bank, Fuji Bank, and the Industrial Bank of Japan. The Asahi-Tokai-Sanwa bank merger has also received a lot of publicity for consolidating three major banks—even though each maintains weak keiretsu connections. But these merged entities cannot boast about their efficiency or streamlined integration. Mizuho, for instance, expects to take three years to complete the consolidation it began in 1999. (Similar mergers in Europe and the United States usually take between three and six months.) Nonetheless, these consolidations are the first steps in the right direction—particularly since they would have been unthinkable five years ago.

As companies interact across traditional keiretsu lines, they are also unwinding their linked shareholding practices. Japanese companies
trying to make themselves attractive for consolidation no longer want to have 40–60 percent of their shares held by related companies. Indeed, soon after the alliance between Dai-ichi Kangyo Bank, Fuji Bank, and the Industrial Bank of Japan, the latter two announced that they would sell the shares they hold in each other. Nissan—which belongs to the same keiretsu as Fuji Bank—announced the sale of its shares as part of a major restructuring plan launched soon after it merged with the French auto company Renault. As these and other shares free up, public companies can sell shares on the TSE. Any company, public or private, can use stocks to purchase assets under the newly legalized stock-swap transaction mechanism, which allows companies to purchase other companies using shares instead of cash. Nippon Paper Industries is doing just that with Daishowa Paper. Or shares can be used to compensate or reward employees, as Nissan-Renault began doing this year.

With company shares becoming valued commodities, they have taken on new importance in the eyes of shareholders, brokers, and management. The newly diversified pool of shareholders—including employees, unrelated companies, and foreign purchasers—can now pressure a company’s management to obey international standards for corporate governance. Although few shareholders exercise these powers, over the past couple of years business terms like “corporate governance,” “shareholder value,” “return on assets,” and “return on equity” have become commonplace in business conversations in Tokyo. The practice of such concepts has admittedly not been as pervasive as the discussion of them. Still, Sony and Toyota have reduced the size of their corporate boards, and Sony and Fuji Xerox have brought in outside directors. Gradually, companies are shifting their priorities from growth and long-term investment to more immediate concerns like restructuring and profitability.

As part of this transformation, the management-employee relationship is evolving as well. Employment guarantees by big companies and the tradition of seniority-based pay have begun to deteriorate. Companies on the verge of bankruptcy can no longer guarantee that they will keep their employees for life. So most firms pay employees
to retire early and have restructuring plans that rely on attrition and hiring freezes, rather than on U.S.-style mass firings. In addition, companies have begun to switch to merit-based pay systems that include stock options and other incentives. This is especially true in the financial, high-tech, and other young growth sectors, but even old-guard Japanese companies are following suit.

Companies trying to enhance their profitability are finally being forced to relinquish their traditional preference for relationship-based business practices—effectively weakening the *keiretsu* system. Although the interconnected relationships run deep in Japanese society, large Japanese companies are beginning to examine business deals on the basis of profit, not corporate connections. These considerations have trickled down to distribution channels as well. Supply chains for distribution in Japan have begun to respond more to pricing and competitive delivery than to company obligations. Nissan-Renault, for instance, caused quite a stir when it announced its plan to trim its supplier relationships by 50 percent over the next three years. But this move is a sign of the times: if Nissan-Renault’s plans succeed in saving Nissan from collapse, other traditional Japanese companies will follow suit.

**REFORM.COM**

Although change is spreading throughout Japan, revolutionary reforms are most prominent in two new sectors of the economy: communications and technology, the same two sectors driving growth in the United States. In the final quarter of 1999, Japanese telecommunications and personal computer companies saw triple-digit increases in their gross profits. In the information-technology sector, productivity has risen 7 percent and output is growing at an annual rate of 12 percent. These changes herald a transformation of Japan’s entire economic structure.

Why are these sectors more instrumental to Japan’s economic revolution? First, unlike old economic sectors such as steel and agriculture, the government does not overregulate the high-tech sectors. Second, individuals in communications and technology are intoxicated with the prospect of catching up to Western technology and profits. And third, those not in the field feel the pressure to develop new models so that they,
too, can take advantage of the profits overwhelming Internet ventures everywhere. The ideas and successes of many Japanese start-ups and technology ventures have attracted unprecedented levels of FDI.

As in the United States, this new economic growth has spawned an entire culture. Japan has its own version of Silicon Valley, named Bit Valley, in Tokyo’s trendy Shibuya district. The name plays on the word shibuya, which means “bitter valley.” In just a few years, a lonely high-tech field populated by a few Japanese entrepreneurs has blossomed into a full-fledged industrial sector. The risk-averse label often applied by outsiders to Japanese business no longer fits the multitudes of Japanese students and others who gladly pass up the safety of long careers with traditional corporations to make it big on the Internet.

The telecommunications industry, too, is undergoing revolutionary changes. Domestic and foreign phone companies are threatening the Nippon Telegraph and Telephone Corporation’s monopoly by laying their own cables, thereby providing services without paying NTT connection charges. Foreign companies are breaking into the Japanese telecommunications sector in other ways as well. Last summer, Cable and Wireless, a British company, outbid NTT to obtain a controlling interest in the Japanese long-distance carrier IDC. Despite NTT’s supposed domestic advantage, Cable and Wireless won approval for its bid from Japanese shareholders.

NTT’s exorbitant rates have kept Japan’s household use of the Internet at less than half the U.S. rate—a sticking point in U.S.-Japanese deregulation talks. But NTT is now facing competition from its own cellular subsidiary, DoCoMo. Because of NTT’s monopoly, cellular phones are less expensive to use than regular phones. As a result, practically all Japanese adults and most teenagers own mobile phones, and DoCoMo has the mobile market cornered. Unlike its parent company, DoCoMo is competitive in pricing, service, and innovation. Recently, it began offering a service that links telephones to the Internet with fun graphics and easy-to-use technology. This service, currently enjoyed by one out of twenty Japanese, lets the personal Internet user escape high connection costs and shows how quickly Japanese technology is moving in leading sectors.
THE CHRYSANTHEMUM AND THE SWORD

OPTIMISM, yes. But Japan’s economic revolution will not succeed without a fight. A great deal of resistance remains in some Japanese circles—justifiably so. The revolutionary changes in the Japanese economy will not bring growth right away. Nor will they end the economic ups and downs any time soon. But eventually, all these fears will dissipate because the economic revolution will bring jobs. It will undoubtedly take a few years for the reforms to become entrenched and for new businesses based on a competitive model to establish themselves. But once they do, jobs will increase and consumer demand will grow.

The speed and efficacy of these reforms will largely depend on how companies and consumers implement them. Unfortunately, the current reforms are neither comprehensive nor universal, and many of the changes have been implemented piecemeal—offering too little, too late. The transition to consolidated tax standards, which would encourage corporations to purchase and revitalize companies with large liabilities, has been delayed for another year, reducing investors’ confidence in businesses’ commitment to reform. The restructuring plans announced by big companies too often rely on attrition and no new hiring, rather than on layoffs, to eliminate redundancies. And although new financial agencies like the Financial Supervisory Agency and the Financial Reconstruction Commission have engaged in significant reforms, they are still limited because of lingering ties to the conservative Ministry of Finance, despite nominal efforts to establish their independence.

Many Japanese companies have backed themselves so far into the corner in terms of overcapacity, unpaid loans, and redundant work forces that they have virtually no good choices left. Without restructuring, they will collapse. But waiting until the last moment to change has only narrowed their avenues of escape. The understandable fears caused by this predicament have translated into high personal savings coupled with low consumer spending, leaving Japan in an interminable deflationary spiral. The enormous fiscal stimulus packages of the 1990s that the government implemented to break this deflation produced nightmarish budget deficits. The combination of all these factors causes some observers to throw up their hands in frustration.
But there is still cause for hope. The revolution underway in Japan will recreate the nation from the inside out. Slowly but surely, Japan is shifting from state direction to a free market. Indeed, Japan's social and political structures already reflect some of these changes. For example, the bureaucracy in various ministries now holds less control over the prime minister's office and the parliament than ever before. Newly elected Diet members are drafting reform legislation with the input of foreign businesses and government officials rather than of bureaucrats.

True, political reforms lag behind economic changes. During the push for reform in 1994, the public showed new interest in eliminating closed-door politics and one-party dominance in favor of greater accountability. But complacency has set in as the ensuing reforms proved superficial. As shown by the lack of public objection to the Liberal Democratic Party's backroom power shift from the dying Keizo Obuchi to the new prime minister, Yoshiro Mori, the public does not expect much disclosure or transparency from its politicians. Fortunately, today's economic reform does not hinge on political reform. The government is not driving the current revolution; business is.

HERE COMES THE SUN

As Japan comes into its own, it could challenge the United States on several fronts. Economically, if Japanese high-tech companies ride the next wave of technical developments—as they are poised to do—they could cut the value of U.S. high-tech stocks and cause the American stock market to drop. If the U.S. stock market falls prey to a high-tech correction, Japanese technology companies could move into the lead.

With regard to national security, a strong Japan that has redefined itself may feel less inclined to follow U.S. policies in the Asia-Pacific region or around the world. If Japan adopts new alliances or policies that harm U.S. interests or undermine U.S. troops in Japan or South Korea, the United States will have to rethink its military strategy for the region—especially if Japan amends its constitution to permit a standing military force. An economically strengthened Japan might also create power and prestige issues for the United States if other
Asian countries look to Japan, not the United States. Despite its recent economic weakness, Japan secured its position as a leader in the region by consistently giving money to the other Asian nations throughout the financial crisis of 1997–98 while the United States held back.

Despite these risks, a vibrant, prosperous Japan is in America’s best interests. Therefore the United States should commit to three courses of action. First, American businesses should not underestimate Japanese businesses’ potential. As they continue to wrestle with formidable competitors in the global economy, U.S. firms should plan on a reinvigorated Japan in five years or so. Second, the U.S. government should continue to work with and support Japan as it struggles to resuscitate its economy. Japan needs to know that America is standing by, and the United States needs to provide quiet and steady support that will not humiliate Japan. Third, the U.S. government and the public need to recognize that America has little leverage over Japan’s economic or strategic policies. So it must revise its expectations of the U.S.-Japan bilateral relationship.

America’s best leverage in this era of globalization is its economic strength. Doors around the world open to U.S. corporations because of the promise of prosperity. The door to doing business in Japan is now open wider than ever. The next U.S. administration should take advantage of this access to support domestic Japanese forces already at work for change. These domestic forces are the engines of the Japanese economic revolution and the key to its inevitable recovery.

The Japanese moved further and faster than anyone ever expected during both the Meiji Restoration and the recovery after World War II. There is every reason to expect that Japan will do so again—winning the battle between status quo and reform. But more fundamentally than even the Meiji and postwar periods, this revolution will rebuild Japan’s economic foundation from the ground up. 

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