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**Draft**  
**Evaluating Koizumi Reforms and the Implications for the Global Economy**  
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**Contents**

<b>1</b>	<b>Introduction</b>
<b>2</b>	<b>Nature of Japanese Systemic Failure</b>
<b>4</b>	<b>Purpose of Koizumi Reform &amp; Its Constraints</b>
<b>5</b>	<b>Koizumi's Leadership Assets</b>
<b>5</b>	<b>Reform Accomplishments to Date</b>
<b>6</b>	<b>Prospect for Further Reform Progress</b>
<b>7</b>	<b>Ongoing Monetary Policy Dispute</b>
<b>8</b>	<b>Koizumi's Foreign Policy Posture</b>
<b>9</b>	<b>New Asian Initiative</b>
<b>10</b>	<b>Koizumi's Active Engagement in Asia</b>

**Introduction**

A year has passed since Mr. Jun'ichiro Koizumi assumed premiership after his surprise victory in LDP (Liberal Democratic Party) Presidential election in April 2001. At the outset he successfully portrayed himself as a fearless reformer to pursue restructuring of the economy. Public at large cheered him when he argued that, in order to regain the nation's economic dynamism in the past, that she should downsize her public sector and secure a larger economic space for the private sector. His unprecedentedly high supporting rate exceeding 80% indicated that public at large shared his view and, more importantly, were tempted to believe that he might be a leader who is

capable of pushing through the necessary reform, irrespective of oppositions within his own party.

One year later, it is fair to say that he has lost much, if not all, of his charisma. His approval rate sank below 40 percent in the most recent public opinion poll. It is true that this rate is still considerably higher than most of ill-fated cabinets in the past. However, it is rather alarming to find that his disapproval rate rose above 40%. Disappointment and a sense of anxiety are creeping in. Critics point out that he is not living up to the expectation in his pursuit of structural reform. He seems to be retreating inch by inch on many fronts in face of obstinate resistance from old politicians and bureaucrats who try to preserve status quo at any cost. Unmistakably Prime Minister is struggling to recapture a momentum in his reform initiative.

Let us turn to the international policy side. It is somewhat hard, from the beginning, to tell where Prime Minister stands. He is very much a politician that was chosen to lead the nation on domestic agenda. Be that as it may, the nation's foreign policy seems to have been somehow drifting. Maverick Foreign Minister Makiko Tanaka engaged herself in an irreconcilable feud with career diplomats, who were kept in considerable disarray. In the midst of resulting confusion, Prime Minister asked Mrs. Tanaka to resign. At this point in time, the new Foreign Minister Yoriko Kawaguchi remains frustrated by a series of mishaps in her efforts to rebuild confidence in the Ministry.

It can be said that Prime Minister demonstrated his resolve to side with the US when terrorists attacked the USA on September 11<sup>th</sup> and later the US military advanced into Taliban Afghanistan. However, on the other fronts, it is rather difficult to identify his individual initiative, especially on international economic policy front. In the meantime, some strains drag on with such neighboring countries as China and South Korea over several issues.

Furthermore, there are several incidents, which indicate that Japan is failing to find its rightful place in the international financial market. The FSA (Financial Services Agency) Minister Hakuo Yanagisawa declared that all the major banks fulfilled BIS capital requirement when he published the outcome of 'Special Inspection on Major Banks' in mid April. However, overseas skepticism refused to dissipate. It is also true that yen continues to be one of the focuses of currency speculation. Moreover, Ministry of Finance put itself quite recently in a dispute, to no avail, with major international rating agencies over their downgrading of JGB (Japanese government bonds).

One naturally has to ask several questions. Why has he lost his credibility as reformer? Does Prime Minister still have a chance to accomplish what he promised? What should he do to reclaim his leadership? Or has he exhausted his political assets? If so, what would happen next? Is there any change in a nature of policy debates with regard to restructuring of the economy and economic stimulation? Is the nation resigned to some more years of muddling through? Is it possible to expect any initiative from Japan in shaping international economic order, when the leadership appears overwhelmed

by domestic problems?

Obviously there are no simple answers to these questions. In the parliamentary cabinet system, any cabinet can't survive a couple of serious blunders. So is Prime Minister Koizumi. There is some truth in saying that reigning the nation is an art of endless series of crisis management. Moreover, each issue is a matter of feverish controversy among opinion leaders. Against these backgrounds, this paper is an attempt to clarify the magnitude and nature of the issues confronting the nation's effort to reinvigorate her economy and to unravel a current state of policy disputes.

### **Nature of Japanese Systemic Failure**

Japanese problems are systemic and deep-rooted in the nation's institutional fabric. One can't correct its shortcomings overnight. Otherwise one can't call them structural problems. In accordance, one has to revisit the fundamentals of institutional set-up of the nation's economic entities. Moreover, there is no doubt that each economist describes the natures of problems somewhat differently from others. Hence anyone's view is subjective. So is mine. But it is hoped that it would still be useful to begin with mine.

Basically, my diagnosis of the Japanese problems is twofold. The first is over-bureaucratization of major institutions. The second is a concurrent overgrowth of the government. The both seem to have a historical root. For the national task at the end of WW2 was identified unanimously as a reconstruction of the economy. In order to accomplish this, rebuilding of strong institutions was believed to be imperative. The strong government was considered as dependable when business institutions were still weak.

Japanese institutions worked beautifully during her high growth era in 50s, 60s, and most of 70s. It nourished good teamwork under lifetime employment practice. It enabled rapid acquisition of western technology. It successfully absorbed baby boomers and escaped acute capital labor confrontation. Together with banks, strong government channeled scarce capital into strategically important manufacturing businesses whose creditworthiness was not adequate enough to attract fund in capital markets.

However, all these institutional assets transformed themselves into liabilities when a catch-up process came to an end in late 70s or early 80s. The economy matured and the growth slowed down visibly. Difficulty in downsizing under life employment practice made wage bills unbearably high, as baby boomers became middle-aged. Blind pursuits of expansion often ended up in meaningless series of diversification, while genuine entrepreneurship was lost.

There is one notable point here. The picture differs strikingly among industries.

To put it differently, Japanese manufacturing sector still appears fairly healthy and competitive. Such brand names as Toyota and Sony exemplify this point eloquently. On the other hand, the service sector remains miserably inefficient. What does this marked contrast in productivity performance mean? It was whether or not industries are exposed to the global marketplace. Unmistakably, it forced incessant restructuring on manufactures, while many service industries are inherently domestic and do not have to face any rivalry from abroad.

Moreover, when one asks which sector is the most shielded from international competition, the answer seems clear. That is the government. It is often alleged that a size of budget and a number of civil servants suggest that Japan has a small government. It is grossly misleading. Taking a wide range of public enterprises and banks into consideration, the nation's public sector has grown into a gigantic player in the economy. For instance, the nation's largest deposit taking institution is Postal Savings whose assets exceed those of the largest 7 private banks combined.

To further complicate the situation, small businesses in service industries and the government seem to have developed a kind of questionable alliance of mutual dependence. As they have strong franchises in respective local communities, these small institutions tend to have strong political power collectively. They often capitalize on this political power to seek protection. The typical argument made was that the government should extend assistance to the small businesses, which could otherwise be exploited by big businesses. Consequently, the inefficiency of service industries was preserved by a variety of subsidies, regulation, public works projects and even quasi-cartel arrangements, which reinforces arbitrary executive power of the ministries in charge. As a result, Japan has become an exceptionally high service cost economy.

### **Purpose of Koizumi Reform & Its Constraints**

If one can agree with these observations, it would not be much difficult to reach to the conclusion that Prime Minister is putting forward his reform initiative quite properly. He does not seem to be just another fiscal conservative. It seems more appropriate to describe Koizumi reform as a public sector reform. It seems to aim at dismantling a political alliance between the government and service sector, which is vehemently defended by the nation's old guardian, namely old generation politicians and governmental bureaucrats. In so doing, the reform intends to open up new business opportunities for progressive private-sector entrepreneurs and to restoring economic dynamism. In fact, public at large as well as private sector economists appear united in endorsing a necessity of the reform as such.

On this account, it can be stated that all the policy and political debates is about means and tactics rather than about end or goals. Certainly the task of restructuring the

economy is not easy, because individuals are so much hostages to existing institutions which are inherently designed to preserve their turf. It is widely understood that LDP and government bureaucracy are the two outstanding defenders of status quo. It should be reminded, though, that they themselves no longer argue against structural reform. They seem to have two reservations, firstly that hasty actions could make pains unbearable for those who can't cope with changes, and secondly that the wholesale reform could run a danger of weakening safety nets too much.

It is true, however, Prime Minister is known to face a host of burdensome constraints. He is not blessed with loyal comrades at political as well as bureaucratic levels. In the first place, he represents a wrong party, LDP that is believed to be at the core of paternal guardianship for inefficient service industries. It is not surprising to find that his campaign slogan was 'change LDP and change the nation'. He meant that a voluntary transformation would be the only remaining practical step to secure the party's survival as a ruling party.

Many observers point out that DPJ (Democratic Party of Japan), the biggest among oppositions, can be a Koizumi's natural ally. In fact, a considerable portion of the DPJ members are those who couldn't tolerate slow progresses in the LDP's self-reform and deserted LDP in the past. Nonetheless, it is in practice impossible for Prime Minister to team up with DPJ unless he gives up on and become prepared to break up LDP. Incidentally, some political commentators speculate that this could happen at a next round of political realignment, which is unlikely to take place soon while LDP currently secures a majority in the Lower House and their term as a House member will expire only in 2004.

In addition, it is extremely difficult for any Prime Minister to control government bureaucrats at his will. It is commonly held that, unlike in the US, each ministry is run by its career bureaucrats, who appear united against any attempt to downsize it. Their strength lies in their expertise knowledge about bolts and nuts of legislation under their jurisdiction. Japanese politicians do not have such other resources of consultation as lawyers, accountants, consultants and independent think tanks. Inevitably, in order to take any legislative initiative, Japanese politicians have to rely upon advices from bureaucrats whose loyalties to their masters are seemingly imperfect. Prime Minister Koizumi is no exception.

### **Koizumi's Leadership Assets**

It seems to me that there are three advantages that Prime Minister has in his quest for structural reform. The first is a yearning for changes, which runs deep among public at large. It is often alleged that people are generally indifferent to how the nation's politics are run as long as the economy is in good shape. However, many public opinion

polls suggest that people are coming to recognize that the economy would not be able to resume its past vigor without some fundamental restructuring. A series of scandals and wrongdoing found among politicians and bureaucrats seems to be intensifying people's distrust in the current state of governance of the nation. Undoubtedly this helps any reform initiative from political leadership.

The second is a reorganization of the government, which became effective last January. The said objective of this reorganization is fourfold: 1) establishing a strong political leadership over policy making and implementation processes, 2) reducing coordination failures among ministries whose jurisdictions appear too fragmented, 3) enhancing accountabilities of ministries, agencies and other public sector institutions, and 4) engineering a lean government through outsourcing and other measures. In order to accomplish these goals, 22 ministries was consolidated into 12. Moreover, Prime Minister's Office will be almost rebuild into the Cabinet Office with enhanced coordinating power.

This reorganization was a political response to persistent criticism in the past, which made out the case that the Japanese parliamentary cabinet system lacks a mechanism for forceful political leadership, which can push through bold reform by overriding institutional inertia of bureaucracy. The reorganization strengthened vehicles available for Prime Minister when he launches his own policy initiative. Currently, it is known that Council on Economic & Financial Policies within Cabinet Office is instrumental in spelling out the Prime Minister's ideas into policy proposals. The State Minister Heizo Takenaka is overseeing the workings of the Council.

The third advantage which Prime Minister Koizumi has is his own resolve and policy expertise, even though there is always a natural limitation on what an individual heroic determination can accomplish. Uncharacteristically among Japanese politicians, he appears to be a reform believer who does not compromise without reason nor fear confrontation. It is known that he is a seasoned fiscal policy expert. Rarely among his LDP peers, he has been consistent in advocating downsizing of the government, privatization of public banks and enterprises, and scrapping Fiscal Investment & Loan Program that finances public institutions on an off-budget basis.

However, this combination of advantages and disadvantages inevitably requires Prime Minister to be crafty and tactical in pursuing his policy agenda. In other words, from time to time he has to give up on small gains in order to derive big gains. He needs skillful sequencing in agenda setting. This makes it extremely difficult to make a fair over-all assessment of his accomplishment and failure to date. To be more precise, every accomplishment is not an entirely one hundred percent victory and does contain some element of defeat.

## **Reform Accomplishments to Date**

In any event, what are his accomplishments so far? Among others, many observers cite the three major development. Each comes with praise and rebuke.

The first tangible installment on his promise was public institution reform. It was decided to abolish 17 out of the existing 118 institutions, to privatize 45, and to consolidate 38 into 36 independent administrative institutions, which is believed to be a more accountable form of institution. The surviving institutions will also have to go through reorganization and regular reviews in the coming years.

Moreover, the detailed directive for privatization was drawn for seven giant public institutions, which include Japan Highway Public Corporation, Honshu-Shikoku Bridge Authority, Government Housing Loan Corporation, Urban Development Corporation, Japan National Oil Corporation, etc.

This appears a great step forward long-awaited privatization of excessive industrial activities by public sector. Nonetheless, there are quite a few criticism among reform advocates that activities seems likely to be transferred to other public institutions rather than to private sector businesses.

The second achievement was a reestablishment of fiscal discipline by placing a ceiling of 30 trillion yen on deficit financing. It is widely understood as his effort to break up alliances among politicians, bureaucrats and special interest groups by slashing public works projects. It is entirely possible for Prime Minister to downsize and redefine an appropriate role for the public sector in the economy in the coming years to come. At the same time, reform advocates is apprehensive in saying that Prime Minister does not fully emphasize reallocation of financial resources. On the other hand, old politicians complain that deficit reduction can be too dangerous for the economy, which is still in a very early and fragile process of recovery.

The third accomplishment is the fact that a financial market crisis, which some pessimists feared toward the end of last March, was somehow averted. Financial Services Agency carried out 'Special Inspection' to streamline NPLs that major banks had against their big borrowers. Strengthening of regulation by FSA on short selling of stocks worked miraculously to lift up stock prices, though it invited harsh criticism from a wide range of market participants. To be fair to FSA, reduction of NPLs has progressed considerably, while it came short of assuring the international investors. Interest bearing debts of the nation's corporate sector is estimated to have fallen to some 80% as a proportion of GDP, which equals the level found in 1985. However, reform believers denounce that FSA is still engaged in delaying tactics.

One should sympathize with the government when it aims at achieving some kind of soft landing. Hard landing can't be a policy objective for any practitioner in charge.

Currently FSA states that its plan intends to reduce a ratio of genuine NPLs to the bank's outstanding loans below 3% within a few years. The problem is their failure to so persuade the market, which still needs to be assured by unrelenting attention from PM Koizumi and his forceful handling of individual cases of difficulty in the months ahead. Economic rebound helps but it still remains to be seen if he could follow through effectively.

### **Prospect for Further Reform Progress**

In addition to these three accomplishments, Prime Minister is trying to put forward another round of reform initiatives. The National Diet is now deliberating on a couple of reform legislations. One is a bill, which would restructure postal service operation into an independent administrative institution and enable partial entries of private sector businesses into postal services. Another is a bill, which aims at controlling growth of medical care costs more properly.

In addition, Prime Minister is preparing some more. The first is tax reform, which seems to aim at eliminating numerous tax breaks for special interest groups and reduce basic tax rates. Secondly, 'Economic Revitalization Strategy Panel' at Economic & Fiscal Policy Council is scheduled to release a series of plans, which includes an interesting idea of 'structural reform zone'. The idea is to create a 'regulation free zone' under leadership of municipalities which invites there a specific group of new industries. The Zones are expected to have a powerful demonstrating effect on further deregulation efforts in broader areas.

It is probably fair to say that it still seems to be difficult to give a final verdict to Prime Minister's restructuring efforts. He is making some unquestionable progresses but at the same time it can be said that the progresses are slow in coming and have many pitfalls. In other words, the process of muddling through is likely to continue for some time. It is not entirely clear if PM Koizumi will be remembered in the history book as a pioneer who is an architect of new chapter in post-war economic history or just as a destroyer of the old system.

It is unfortunate for the Prime Minister to be struck by a series of scandals and wrongdoing of politicians as well as bureaucrats in the recent months. These eroded trust in his stewardship of the nation considerably, even if he is not responsible. There is no doubt that his political assets are waning and he needs some political wins against old politician and bureaucrats to reconsolidate his leadership.

One encouraging sign, though it is not noticed widely, is that the corporate sector seems to begin to respond to his reform initiatives. Corporate restructuring and consolidation are accelerating. In the old system, private sector businesses were hesitant to demand

deregulation aggressively, because it could compel them to give up on their old privileges in return. Now they have come to reckon that their vested rights would be taken away sooner or later. They are becoming keener to identify new business frontiers and to lobby for necessary deregulation. If the nation's political leadership successfully continues to sustain reform momentum, then it is possible to expect a return of confidence in economic dynamism of the nation in some future point in time.

### **Ongoing Monetary Policy Dispute**

A few words deserve another couple of ongoing policy disputes. The first is the one between what-I-call reflation-first school and reform-first school. PM Koizumi is of course a champion of the latter in arguing for 'no growth without reform. Old LDP politicians argue that hasty reform could wreck a chance of any steady recovery and thus make further reform impossible. To be more specific, the current focus of debate is whether the nation should cut tax first even if it aggravates fiscal drain for the time being. It is true that tax cut is always one of the effective tools in crisis management. At the same time, however, it is possible that a recovery could progress so as not to need another stimulus policy package.

The second source of policy disputes is over monetary policy. Some renowned economists, domestic and overseas, argue that Bank of Japan can do more. Also with some strong support from private sector economists, BOJ argues that the bank can't supply more liquidity when interest rates stand at nill. They indicate that a slow expansion in monetary supply is a reflection of lack of demands for funds in a serious recession. Consequently, BOJ suggests that the government pursue structural reform to enhance the nation's growth potential so as to overcome deflation.

It appears, at least theoretically, possible to increase money supply further. The first is to employ negative interest rates. The second is for the central bank to purchase domestic securities in the market irrespective of their creditworthiness beyond long JGBs. The third is for BOJ to sell yen and buy dollar securities. This is expected to let yen depreciate, import inflation from abroad and reduce real interest rates, which could in turn stimulate domestic investment. The debates among academics seem to remain unresolved. The practitioners tend to think that the last two means are actually not within discretion of the central bank but within that of fiscal authority, which does not appear prepared to resort to these means.

### **Koizumi's Foreign Policy Posture**

In any event, domestic agenda is consuming so much energy of political leadership that it is somewhat difficult to identify conspicuous initiatives on international economy policy

front. In other words, the nation's leadership acknowledges the fact that the greatest contribution that she could make is to secure a recovery for herself. Fortunately a recovery seems to be happening, as a recovery in the US and other regions of the world progresses and increase net foreign demands for Japan's supplies. Unfortunately, one has to assume that Japan can't be an independent locomotive for the world recovery. However, at the same time, PM Koizumi is aware of the international responsibility so as to do anything to make sure that the nation's NPL problems should not disrupt the process of the world economic recovery.

It can be pointed out that September 11<sup>th</sup> altered international policy agenda for most of the nations. This obliged PM Koizumi to put a great deal of vigor into policy coordination with the US and others in the fight against terrorism and also into implementation of necessary legislative changes. PM Koizumi did so remarkably well and even volunteered to host a conference for reconstruction of Afghanistan in Tokyo. However, it is also true that his time to deliberate upon other policy agenda was considerably squeezed.

All these constraints seem to be contributing to make Japan's posture somewhat reactive rather than proactive, at least at this point in time, in areas of rebuilding global governance, such as international financial architecture and trade and investment system. Certainly, there are some exceptions like Kyoto protocol on environment, which Japan chose to join Europe to ratify and in so doing diverted intentionally from the US posture. Yet there are not many other cases that the nation's leader put much weight on formulating policies in these spheres.

This does not mean, however, that the Japanese government is dormant. It has been a very diligent participant throughout the G8 related meetings in their efforts to rebuild international financial architecture and other governance enhancing mechanism. Moreover, the Japanese government is known to seriously implement consensus decisions as exemplified by the recent strengthening of measures against money laundering. In practice, the Japanese government couldn't help but explaining any progress to some great length in its effort to put her economic house back in order.

To put it shortly, most of the Japanese government's efforts seem to have been somewhat concentrated upon presenting the Asian cases and letting their specific concerns incorporated well into the consensus. It is reflected, for instance, in the Japanese posture concerning pros & cons over issues of private sector involvement. Japan may appear to lack distinct viewpoints on stand-still power and collective action clause.

This is not accidental because Samurai bonds, which were issued by Asian government and held by Japanese investors, were extremely a marginal factor in the Asian financial crisis, while bond financing was a major part of external debt financing for Latin American and East European governments. In fact, the Japanese government is trying to

foster healthy development of regional bond markets in Asia, in order to encourage inflow of long-term capital and reduce dependence upon that of short-term money from abroad. It is expected that the outcome of ongoing PSI discussions will be blended properly into the process of designing the region's bond markets.

### **New Asian Initiative**

In any event, a new Asian initiative is currently one of the most notable initiatives that the Japanese government is taking in the area of international economic policies. It does not imply that the Japanese government is becoming less enthusiastic about multilateral or global efforts and embarking upon regional route to pursue its national interests. On the contrary, the Japanese government is employing extra cares in ensuring that any regional arrangement should not become an obstacle for further multinational arrangements.

Certainly, the Japanese government altered its policy posture considerably in the recent past. In the prior period, its priority has always been placed upon multinational approach such as WTO. Now the Japanese government has decided to pursue accomplishments at any conceivable level, namely bilateral, regional and global. This change in posture stems from recognition of changing policy environment.

To begin with, it appears that many things are achievable at bilateral and regional levels as represented by the recent FTA agreement between Japan and Singapore, while the next round of trade liberalization at WTO may not be able to produce quick results. The Japanese government came to reckon that it is possible for bilateral and regional arrangement to nourish the further thrust toward global approach. Another consideration is that the Japanese government could be most effective in forging appropriate adaptive applications of new global governance architecture in the Asian region.

There is a growing awareness among nations in the region that they have common stake in enhancing their standing in the global market place. Most of the region's nations are far keener than before in participating in a variety of consultative mechanism, collective arrangement for mutual actions toward building -up of safety nets, collective infrastructure and harmonization of the regulatory systems. There is no doubt that extensive mutual economic dependence through trade and investment convinced nations of a waste in seeking one's own benefits at the expense of others. Moreover, China made a dramatic turn in its policy posture to participate aggressively in this process of deepening of economic relations within the region. This changed the region's political equation subtly but has been cautiously welcomed by other nations.

### **Koizumi's Active Engagement in Asia**

In light of these changes in environment, PM Koizumi seems to commit himself to a new Asia initiative, in which Ministry of Economy, Trade and Industry, which Minister Takeo Hiranuma heads, functions as an effective engineer of the details. PM Koizumi made the extra trouble to visit the rest of Asia already several times. A series of the speeches that he made during the tour are revealing. PM Koizumi proposed a novel idea of 'comprehensive economic partnership'.

This partnership is intended to include not only further bilateral or regional trade and investment liberalization but also a wider spectrum of mutual efforts in the areas of environment, currency and collective infrastructure building. The last emphasizes cooperation in science & technology policy making, enhancement of educational exchange, harmonization of industrial regulation, and promotion of tourism among participating nations. It is based upon a conviction that incompatibility of regulations and infrastructure could be nothing but a fatal hindrance to further economic growth of the region.

Along these lines, some progress are seen also in the area of strengthening of the region's financial system, although individual nations are still struggling to reduce debt overhang of her financial institutions as well as industrial corporations. Japan has been entering into currency swap and dollar repurchase arrangement with several nations, in following-up on Chiang Mai Initiative. Forums for consultation on macro-economic management among the region's fiscal and monetary authorities have become far more frequent and intensive. It appears that some peer pressure for reform is beginning to grow, if it has not yet evolved into a binding mechanism. Rebuilding of financial market and institutions is no exception. Dialogue to identify appropriate sequencing of financial market deregulation is flourishing.

It is probably fair to say that Japan, through her Asian initiative, could well contribute most to rebuilding of global governance as well as international financial architecture by keeping Asian nations actively committed to the whole process of policy deliberation as well as implementation.