

## Views from 2020

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**Do Japan's financial troubles doom it to stagnation, or might it rebound as Asia's strongest and most vibrant country? Here Tadashi Nakamae, an independent economist, draws up three possible—and plausible—futures that could arise from Japan's current difficulties\*.**

AFTER bumping in and out of growth and recession during the 1990s, the past few months have been traumatic for Japan. Just as recovery seemed to be beginning, Asia's financial collapses have cast a new and uncomfortably penetrating light on the problems of Japan's own financial institutions. In truth, however, this new light has merely exposed an old reality: that Japan has failed during this decade to tackle the roots of its financial, economic and even political problems. Will that failure now be repeated? And if so, what would it mean for the country's long-term future?

One way to provide an answer is simply to speculate. There is, however, another more interesting technique. That is to interview more than 100 people involved with Japan in Asia, Europe and North America and then to collate their visions, worries and expectations into possible scenarios for the course Japan could follow during the next 20 years or so. Such "scenario planning" is not intended to offer a fixed forecast; rather, it helps to show how today's trends and challenges could shape tomorrow's Japan.

With the help of a specialist scenario-planning firm in San Francisco and London, Global Business Network, I and my colleagues have developed three main scenarios, which this article will describe, in the style of a historian writing in 2020. The first scenario reflects many people's fear that Japan will fail to make necessary structural changes, thanks to lobbying by anti-reform interest groups and a general failure to confront reality. The second scenario is more optimistic, plotting a course through which the interest groups' power is broken and a virtuous circle of reform develops.

The third, however, throws a geopolitical spanner into the works: it explores the debate that a withdrawal of America's military presence in Asia would prompt, since it would force Japan to ponder its position in a region that has come to be more dominated by a growing China. This third scenario reaches 2010, conceived as the eve of a decisive vote on the sacrosanct Article 9 of the post-war constitution, which in effect forbids military action by Japan except in self-defence.

And the conclusion? First, that no conclusion can be confident, once all Japan's complexities and challenges—environmental problems, the ageing population and Asian geopolitics as well as the familiar financial and economic issues—are taken into account. But also, second, that history suggests a clue for the future: that Japan is spurred into action only by a truly visible crisis or shock. For that reason, the present financial slump could prove a blessing, albeit disguised.

## 1: The long hollowing

In this first scenario, Japan's structural problems remain unreformed with the long-term result that the brightest and the best in Japan, both individuals and companies, leave the declining country.

The seeds of the problem were sown in 1998-2000 when the Bank of Japan intervened to support the banks rather than accept the reality that banks needed to fail and that even depositors might have to lose money. Some banks merged, some foreign firms came in as part of the rescue, but the structures remained the same.

This failure to confront the problem and to defeat interest-group pressures meant that the critical momentum for other reforms in Japan was never established: at stake was far more than just fixing a banking problem. But at the time the central bank felt that once again it had succeeded where many had doubted Japan's resilience. After all, hadn't people been trying to write off Japan through most of the 1990s? Wasn't the bank rescuing Japan from a 1930s-style depression? The illusion that something was being done to improve structures was reinforced by a series of nominal reforms which in reality left regulation intact and the bureaucracy still in full command.

The so-called financial "big bang", promoted in 1997 by the-then prime minister, Ryutaro Hashimoto, turned into the big sigh, as passive lending by banks to companies over which they had little control remained the norm. Even the foreign banks that came into Japan during the crisis were content to operate under this protected system. Indeed, the limited competition that was introduced made members of the *keiretsu* industrial groups even more protective of each other, strengthening bank-company ties.

This perpetuation of a closed financing system which had served well in previous years was now a big handicap in world markets, especially as it continued to protect inefficient industries. Japan retained its dual economy of weak, domestically focused firms and a competitive export sector. The changes triggered off by foreign companies coming into Japan did nothing to alter the structure of the economy as a whole. Only around half of the population turned out to vote at elections, content to accept politicians' assurances that change was being enacted, or else merely showing their apathy.

These problems were worsened by the lingering aftermath of the Asian financial crisis which had damaged Japanese investments in the region. By the early part of the new century the drive by Asian economies to rebuild their strength led them to redouble efforts to entice more firms to locate in their economies, a process helped by the new post-devaluation competitiveness of Asian currencies. Japanese companies grew, but outside Japan.

Perhaps most critically, China was struggling to deal with its own challenges and beginning to assert its growing military power to divert attention away from its economic and resource problems. The United States made China the focal point of its Asian strategy, whilst continued trade friction

undermined America's relations with Japan. The economically weak Japan had become a spectator of events in Asia.

Within this limping, sidelined Japan the confidence of the young was further undermined by accumulating environmental deterioration. For example, the country was running out of waste-dumping capacity. Dioxin problems were worsening as more waste was burned. Illegal dumping of waste intensified outside the urban areas where controls were lax. The official reaction? To do nothing, but to excuse the relaxation of standards as they had been higher than in other countries.

If Japan was becoming an increasingly unpleasant place in which to live, for the young in particular the demographic pressures were the most depressing. Japan was rapidly shifting from becoming the youngest of the industrial economies to the oldest. The older generations were taking action, setting up lobby groups to protect themselves. In 2002-03, to pay for pensions, special income taxes were imposed and unemployment benefits were cut. Older workers were being protected in jobs as far as possible, whilst the young were having to be part of a growing "contingent" labour force, accepting more part-time and temporary work.

For the first time in its history Japan experienced significant labour emigration as the young began to depart. The loss prevented Japan, already one of the least "wired" countries, from exploiting new technologies. The departure of the young was matched by the exodus of competitive companies. The new products of the IT world were made elsewhere.

By 2020 those Japanese now outside the country tended to conclude: "It has become a wonderful time to be a global trading firm—not a great time to be in Japan."

## **2: Crash and rebirth**

The second scenario, by contrast, is more optimistic. This explores how Japan could make an impressive turn-round, beginning with, perhaps, a 1999 “bank-holiday crisis”, a turn-round which ends up with Japan firmly established as a respected world leader two decades later. In such circumstances, alongside the United States, Japan could use its advanced technology to ensure that China can ease its food and energy constraints without resorting to a destabilising takeover of the resources of Central Asia or the South China Sea.

The first building-block of this success story was the willingness to confront the financial crisis of 1999, establishing the momentum for reform by taking Japan out of the grip of anti-reform interest groups. The new accounting self-assessment system for bank assets, introduced in 1997, began to reveal the extent of the banks’ balance-sheet weakness in 1998. By 1999, after a year of trying to support the banks, the government finally gave up the attempt, overwhelmed by the size of the problem and market pressures. The ensuing collapse of bank share-prices, linked to an accompanying fall in other equity prices and an attempted unloading of cross-shareholdings for self-preservation, precipitated a new financial slump. The yen plummeted and the minister of finance closed banks’ doors to stop panicky withdrawals of deposits.

The rescue package then presented froze 25% of deposits of banks and postal-savings accounts into 20-year zero-coupon government bonds, using the resources to write-off all bad loans. All remaining bank deposits were guaranteed. Massive cuts in bank staffs and the resignation of bank directors followed with the banks’ promises of deposit guarantees. The long-term benefit of this traumatic solution was to force a more open relationship between finance and business.

These actions were followed up in October 1999 by a radical set of administrative reforms, requiring government companies to disclose and write off their hidden losses, a 30% cut in government and bureaucracy costs, extensive tax reform, industrial deregulation and the privatisation of pension funds. Such radicalism triggered a predictable counter-reaction by threatened interest groups but the reforms were endorsed in an election that returned a party by then called the Reformists, thanks to a massive jump in voter turnout, from 50% to 80%. Spurred by the shock of the banking crisis, Japan’s previously apathetic people had realised that the momentum for reform had to be sustained.

The election also saw the younger generations beginning to take more control. Reforms began reforms, especially as positive results came through: after just five years, the nationalised banks were being returned to private ownership. Critical social reforms were enacted from 2008 onwards, for example encouraging more women to work and to marry, to raise fertility. Nor were the needs of the ageing population ignored. Policies to allow people to work longer helped to ease the burden on the pension funds (themselves now in better shape after pension-fund reform). Educational reform made students more flexible to meet the creative challenges of the knowledge economy. Some immigration was encouraged and finally the lifetime employment and pay-by-seniority systems were dismantled.

Building on these reforms, from 2010 on there was a more conscious effort to improve the environment, giving incentives for pollution-control technologies, for new agricultural technologies, for recycling and for more R&D into the problems of global warming and ozone depletion. The emergent environmentalist culture in Japan gave a boost to “green” technologies, led by car firms, who were now able to follow up their early successes in introducing the world’s first green cars in the 1990s. Research cut sulphur and nitrogen emissions drastically. Breakthroughs cut dioxins, thereby helping to combat the fall in the fertility rate. Many of these new technologies also generated profitable new business in China’s booming market.

It was indeed China which provided the arena in which Japan’s advances paid off. The demand for grain in China, which needed to feed a further 12m people every year, and its massive rise in energy consumption, had encouraged the Chinese government to cast its eyes westwards, to the resources of Central Asia. Tensions rose as America and Russia took steps to block China’s moves to take over these resources. Japan, bound to peaceful action only by Article 9 of the constitution, was desperate to prevent conflict in Asia which would damage trade and would destabilise the region profoundly.

After three years of tension, in 2018 the Japanese prime minister proposed a tripartite solution whereby the United States and Japan used their advanced technologies to assist China in improving crop yields and increasing energy efficiency. This event signalled Japan’s ability to meet its many challenges. Without the advances pioneered by its new, technologically astute young workforce, conscious of the need to protect the environment, a peaceful solution to the geopolitical tensions of Asia might not have been found. The China solution was the symbol of the success of the new Japan, a nation reborn from the seeds of the tough measures taken to confront structural weaknesses at the turn of the millennium.

### **3: Hercules departs**

The third scenario is not, in truth, an alternative to the first two. But it describes and elaborates upon the biggest single external shock that could shape Japan during the next two decades. This could occur regardless of which of the first two scenarios comes about; and if it does, it will greatly complicate Japan's situation.

This shock is the withdrawal of American troops from Asia, which would pose big security dilemmas for Japan. The result, in this scenario, is that in July 2010 Japan is engaged in an intense debate over whether to amend Article 9 of the constitution, which in effect forbids military action except in self-defence. Japan faced the need, for the first time for 65 years, to look after its own security.

America's troop withdrawal was driven by a number of circumstances. Within the United States itself, as the economy slowed in 2001-02, the Republican president looked for ways to husband fiscal resources so as to allow a recovery by the 2004 election. At the same time, more Americans were expressing their discomfort with their country's role as world policeman. A war hero, the president was able to use his reputation to take advantage of an opportunity emerging in Asia.

In Asia the American military presence looked more and more anachronistic as some key issues edged towards some sort of solution. First, as the North Korean regime crumbled in 2002-03 and the two Koreas finally united, the United States agreed to reduce its presence in return for an agreement by China to stay out of the Koreas. In January 2003 the president announced his new policy, redeploying troops from forward positions to Hawaii by 2010, leaving some based in Guam. The Security Treaty with Japan was preserved, the idea being that new military strategies and power-projection capabilities would allow for this troop pullback. Worries about China's size and weight remained, but were at least assuaged by its still-peaceful proprietorship of Hong Kong. At first there was little obvious reaction in Asia.

But in 2005 China began to test the waters with some subtle but noticeable discrimination against Japanese companies in China, to gauge the strength of a Japan with reduced American support. In 2007 China went further, by suggesting quietly that companies operating in Taiwan might be less than welcome in China. America looked the other way, in stark contrast to the explicit warnings given almost a decade earlier during the Taiwan crisis of 1996. Taiwan realised that accommodation with China was likely to be necessary.

By 2008 Japan was in an increasingly difficult position as reality began to sink in. Five separate factions emerged in the debate over Japan's foreign and security policy. Of the five, only the Pacifists held out against a revision of Article 9.

The Nationalists called for Japan to shake off the whole panoply of its American-based constitution and economic system and to reassert Japan's rightful place in the world—at home to re-establish Japanese values and abroad to resist Chinese imperialism. The Pacifists, in contrast, believed that

peace still could be attained through diplomatic means. But while vocal, the Pacifists tended to be disunited and many Japanese saw this approach as being too risky.

The third faction, the pro-America Conservatives, called for a rebuilding of a strong relationship with the United States in order to facilitate unrestrained co-operation between American and Japanese forces. The fourth, Pan-Asian faction, preferred Japan to try to engage China not to isolate it, and to work towards a Pan-Asian multilateral security framework, involving Japanese forces.

Finally, the ASEEAN faction (advocating an Association of South-East and Eastern Asian Nations) also favoured a more Asian solution but one where nations of ASEAN and the United Koreaes should build a security arrangement to counter the power of China. America was not to be trusted and Japan would need to rebuild its forces.

Whilst the vote looked as if it would swing in favour of Article 9 revision, whatever the result, the future of foreign policy is uncertain. With American support departing, the very identity of Japan was at stake.

Of course, this may never happen. But what if it did?

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*A full copy of the scenarios can be found on the Internet at [www.gbn.org](http://www.gbn.org) and also in English and Japanese on [www.nier.co.jp](http://www.nier.co.jp), or obtained by e-mail on [foj@nier.co.jp](mailto:foj@nier.co.jp) from Nakamae International Economic Research.*