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Why Japan is under fire from abroad

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International criticism of Japanese economic policy is becoming increasingly harsh. I have witnessed intense criticism of Japan on trips abroad over the past 40 years or so, but never as severe as that seen now. What has prompted it?

It appears that U.S. government officials, scholars and journalists are the driving force behind criticism of Japan, with some corporate executives agreeing with them, and there is support from similar groups in Europe and Asia.

The basis of their criticism is clear.

First, they are aware that the Japanese economy is in extremely critical condition.

Second, they see that Japan is not taking the steps necessary to overcome the crisis.

Third, they fear that the failure of Japan's economy would exacerbate the crisis in Asia, undermine U.S. prosperity, and induce a global slump.

The criticisms, however, should not be dismissed just as emotional arguments. Why do they feel that Japan is in such dire straits? There seem to be three primary reasons.

First, the overall Japanese economy appears headed for a recession. Major economic indexes—consumption, output, investment, corporate earnings, employment and consumer prices—show the economy is in a deflationary spiral. Financial policy has lost momentum, stock prices are on the decline, and the yen's value against the dollar is dropping.

Next, management of Japanese financial institutions is unstable.

Banks became saddled with huge nonperforming loans after the collapse of the bubble economy, and seven years later, the debt problem remains unresolved. A succession of financial institution failures last November demonstrated the gravity of this situation and caused great concern overseas. Given the currently deteriorating economic climate, the amount of bad loans could grow.

Furthermore, there are risks regarding overseas assets if economies remain stagnant in East Asia. In that regard, many financial institutions could face collapse due to a shortage of capital and a deterioration of earnings. The government has yet to implement measures to weed out financial institutions that cannot survive competition and to strengthen competitive ones in an effort to heighten the credibility of the nation's financial system as a whole.

Uncertainty has been exacerbated by a string of scandals involving securities firms and banks. The majority of these scandals involved practices widely tolerated until a few years ago, but now outlawed as a result of changes in the rules of the game. These practices could be termed a chronic disease of Japan, but the scandals created the impression abroad that the financial system had suddenly begun to crumble.

Furthermore, there have been developments that defy conventional wisdom abroad. These include top officials being forced by social pressure to resign for subordinates' illegal actions or violations of work rules, as well as a spate of suicides, which has contributed to anxiety about the overall financial system. Authorities in other countries fear that government officials responsible for supervising the financial industry have succumbed to a kind of paralysis.

The third problem is whether Japan will be able to carry out the structural reforms needed in the medium and long term. Critics say the nation must deal with the rising fiscal burden of an aging population, reform the industrial structure, and reinforce competitiveness. To do so, they say Japan will have to change the government's budget structure, carry out thorough deregulation to encourage the birth of new industries—and hence employment opportunities — and invigo - rate the capital market.

Although some critics are obviously seeking publicity or have merely jumped on the bandwagon, criticism from others persists for two fundamental reasons.

First, if the Japanese economy fails, it would deal a blow to East Asia and the United States. Many feel that the Asian financial crisis has been contained, at least for now, though Indonesia continues to be troubled by political unrest.

Hardships are inevitable for all the countries affected by the crisis. The problems they face include currency plunges, austerity measures, large - scale corporate restructuring, rising unemployment, the abrupt inflow of foreign capital and low economic growth.

How Asian nations will ride out this situation remains unclear. China and Hong Kong seem to be coping with effects of the crisis for now, but are feeling pressure from the economic stagnation and the slowdown in growth. East Asia could see a recurrence of the recent chaos if China and Hong Kong were to devalue their currencies.

Japan's economy is roughly twice as large as those of all other East Asian countries combined. More than one - third of exports of other East Asian nations come to Japan, which accounts for nearly 40 percent of the region's external debt. Thus, the East Asian economies rely on Japan to absorb their products and to obtain the needed capital. This dependence also fuels fear of a Japanese economic collapse.

Meanwhile, the U.S. economy can be likened to a full moon. Adjustments will become necessary in view of a rise in funding costs, a slowdown in the improvement of corporate performance, and an expansion threatening to exceed growth potential. The most important issue for the administration of U.S. President Bill Clinton is how to effect such adjustments with the approach of a midterm election in November.

Deterioration of the Japanese economy—in particular the collapse of its financial system—would create chaos in international financial markets, and threaten the U.S. scenario for a soft landing.

Another reason for the continuing criticism is that the critics are convinced that they have been correct in the past. For example, when the issue of liquidating failed jusen housing loan companies arose, critics called for immediate action on the problem of non - performing loans, even if it meant using huge amounts of public funds. However, Japan took a gradual approach, which failed to produce results. Things came to a head in November last year, forcing the government to reverse policy and devote 30 trillion yen to damage control.

Critics also took a dim view of plans to raise the consumption tax rate, end special tax cuts, and reduce public works spending last spring. They said the government was insane to take such measures in light of the weak economy, but their advice was ignored. Fiscal austerity measures were adopted instead, and the economy subsequently deteriorated. This led to a reversal of policy, with the government drawing up stimulus measures, including restoration of the special tax cut.

With the recession worsening from the autumn, critics abroad argued that Japan should make use of fiscal policy because there was little leeway in the area of monetary policy. However, the Fiscal Structural Reform Law had just been enacted and the government headed in the other direction. Economic conditions worsened rapidly, and reluctantly the government decided to consider ways to apply the new law in a flexible manner.

In short, foreign critics are convinced they were correct in their assessments and that was why Japan changed its policy in the end. This is very troublesome for Japan.

Japanese politicians, bureaucrats, and business leaders once cooperated behind closed doors in formulating policy. The troika demonstrated a tremendous ability to lead and created a dynamic economy. However, there have been dramatic changes in the world economy in the past 20 years. Capital flows now move globally, while advances in information technology have brought historic changes not only to industrial structure, but also to Japanese culture, corporate management and politics.

Unfortunately, the troika has not been able to keep up. The efforts of the individual groups to maintain vested interests have given rise to inertia. Attempts to break the logjam and create a new system of governing have not borne fruit. Many Japanese apparently share the feeling that the three - party union should be destroyed. Recent attacks on the bureaucracy are an expression of such feelings. As a result, the power of bureaucrats has diminished conspicuously, but there have been no constructive moves to create a new bureaucratic system. Bureaucrats are unable to create something new because they are busy recovering from the destruction.

Meanwhile, the single biggest problem facing business may be summarized in one word: restructuring. Emotional dependence on vested interests should be abandoned in favor of thorough restructuring, but business appears hesitant to take decisive steps.

Uncertainty over Japanese economic policy in this time of transition is a cause of misgivings in other countries. Such confusion in recent years has largely stemmed from an inability to pinpoint who is responsible for setting policy. Those believed to be responsible for economic policy offered different views on the substance and scale of measures yet to be worked out. Rather than respecting market principles, they made remarks that were apparently attempts to influence the market. Naturally, the market was left puzzled and disappointed. It also led to growing distrust of government policies. The argument heard most often was that, in terms of economic policy, Japan had lost its rudder.

Britain and the United States faced harsh economic conditions in the 1970s and 1980s. Although various lucky breaks helped put them on the comeback trail, what was most significant was political leadership. Strong leadership meant that clear policies were set and then executed, based on medium and long term perspectives, to streamline government spending, cut taxes, scale back the government, and invigorate markets through privatization and deregulation.

In Japan, confusion is likely to continue in the economy during the transitional period. Only through political initiatives can the turmoil be ended, and politicians alone bear responsibility for this.

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