

# Newsletter



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## **Changing Asia, Changing Japan**

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Just like any decade in the past, the last decade was full of events which affected the Asian economy in one way or another. First, there was the Asian financial crisis and the recovery from it. Second, the Chinese economy achieved phenomenal development and thus enhanced its global presence. Third, the Japanese economy, which accounts for two-third of the region's economy, has stagnated since the collapse of the bubble economy in the early 1990s. Let me briefly reflect on what actually happened in three episodes.

In the financial crisis of 1997, East Asian countries were the first victim of globalization, characterized by the global sharing of information and globalized free flow of massive capital. The affected countries were indeed not prepared to face the impact of globalization. Their banking system was vulnerable to large risks. Their financial supervision was flawed and ineffective. Their corporate governance was not tuned to the scrutiny of global markets.

Unaware of these serious shortcomings, the affected countries opened up their capital markets, prompted partly by the desire to attract foreign money to boost domestic investment. Also, they succumbed to strong pressure from the US Treasury and American financial multinationals that preached the benefits of capital market liberalization. The

lesson that affected countries learned from the crisis was clear. First of all, it is absolutely necessary to build a strong financial system supported by rigorous supervision and credible governance. They also learned that capital liberalization must proceed under prudent and realistic programming.

Fortunately, on the whole, East Asia recovered from the damage of the crisis reasonably well. Several factors contributed to the good outcome, including the worldwide IT boom that developed in 1999 which supported exports, and effective regional and multilateral supports. The most important factor, however, was the effort by affected countries themselves to carry out needed reforms. Indeed, in some cases, reform was forced upon them by sheer market force, but in other cases governments demonstrated conscious leadership.

The success of Korea was an exemplar in this respect. Korea weathered the shock of the burst of the IT bubble in 2000 and resumed growth. In my view, the success was attributable to the efforts made in four major areas. The first was the restructuring of inefficient banks and business corporations. The second was the encouragement of new venture business and service sector employment. The third was the shift of the labor force from old industry to new industry. The fourth was price adjustments and enhanced international competitiveness.

Recovery in other parts of East Asia is not as remarkable as in Korea. However, it is fair to say that most East Asian countries have made commendable achievement in shifting toward domestic-led growth, strengthening service sectors, and enhancing regional cooperation. Compared with five years ago, East Asian countries have ample reserves and lower external debts. The domestic political situation is, on the whole, more stable than at any time since 1997. Most of the virtues of East Asia that contributed to accomplish the Asian Miracle in the 1980s, such as strong entrepreneurship, a young and hard working labor force, high savings, and widespread aspiration to development, are still intact. In sum, I would argue that the strong progress of East Asia was interrupted by the crisis of 1997, but it was not halted. Asian tigers were wounded but they will come back roaring with greater wisdom and resilience.

The emergence of China as a great power during the last decade was truly spectacular. With astonishing speed, China has converted itself to a world center of production not only in low-tech manufacturing but also in increasing numbers of high-tech products. China is

also developing as the world's largest consumer market.

China's success was made possible by the combination of many factors. The most important of them was the skillful policy management of the government. Since the bloody demonstration at Tienanmon Square in 1989, the Chinese leadership has resolutely pursued two major goals of national policy management. One was continued economic growth, and the other was the maintenance of social and political stability. To achieve rapid and sustained growth, the government, first of all, heavily depended upon an expansionary fiscal and monetary policy. Government is financing large-scale infrastructure projects one after another. Government employees' pay and salary were raised. State-owned banks are continuing to provide credit to state-owned enterprises. Also, China succeeded in attracting large inflow of foreign direct investment, particularly in wide-ranged manufacturing sectors. Furthermore, private business people were allowed to demonstrate dynamic entrepreneurship to seize variety of business opportunities. The combination of these three policies has clearly been the key to the phenomenal emergence of China as a global economic power in the 1990s.

Economic growth and political stability are two pillars that support today's China. They are inseparable and interdependent. The Communist Party dictatorship is indispensable for the time being in order to maintain social and political order, and continued improvement of the living standard is the prerequisite to convince the people of the legitimacy of the regime. On top of good economic performance, a gradual introduction of democratic procedures into the political mechanism and relentless suppression of anti-regime movements have enabled the government to maintain overall peace in the society. It is certainly arguable that China is now in a historical phase of national ascent. People of China are now elated by the sense of national pride prompted by such events as APEC meetings, the accession to WTO, and Olympic games. All in all, the Chinese leadership, through its remarkable skill, has elevated the country to the status of a global power in a matter of two decades.

The future of China provides extraordinary possibilities. The sheer size of its 1.3 billion population which is perceived as a formidable power in production, consumption and fighting, combined with the high speed of growth, can easily dazzle observers. However, it is also possible to draw a picture of China's future as one full of problems and uncertainties. For instance, it is obvious that China cannot afford to continue the current fiscal spree for a

long time. While national debt is piling up, the need of further burden is forming a long queue that includes the disposal of NPL of banks, restructuring of state-owned enterprises, and improvement of the social security system. The acceptance of WTO liberalization obligations will intensify competition with foreign firms. State banks and state-owned enterprises, many of them already technically bankrupt, require overhauling without delay, an exercise with big finance and employment costs. If the rapid expansion of economic activities is to continue, the stable supply of energy resources and food, and preservation of environmental safety will become an urgent issue. In the shadow of spectacular economic development, the income gap between rich and poor, between cities and farms, between coastal regions and inland is growing. The introduction of capitalistic market mechanisms provided a strong boost for people to become innovative and hardworking, seeking greater personal wealth. Greed, on the other hand, fertilized the ground for rampant corruption of all kinds among civil servants and business people.

In sum, strong momentum of growth is still prevalent in China. It is likely that China will continue its great leap forward during the first decade of the century and its role in the world economy as a major producer and consumer will be greatly enhanced. The long-term prospects for Chinese development will depend on how successfully China can deal with the various problems mentioned above. It should also be noted that China's economic development is closely linked to its social and political maturation. When China has succeeded in a smooth transition to a free and open society, China will be able to secure its status as a regional and a global leader.

The Japanese economy has been stagnant during the last decade after the collapse of the economic bubble in the early 1990s. The causes of the unusually long stagnation was indeed complicated. Put bluntly, the stagnation was created by complacency due to memory of past success. Japan basked too long in the glory of almost miraculous recovery and development during the 1960s and 1970s. As a result, Japan ignored the sea changes that occurred in the global environment as the result of the irreversible trend of globalization. In hindsight, it was obvious that Japan needed to alter the structure and operation of its markets and systems of governance in corporations and government. The modus operandi of the Japanese economy worked wonderfully in the protected and non-competitive environment which prevailed until the 1970s. However, in the rapidly globalizing market since the 1980s with the free flow of capital and information, the key words are global competition, transparency and

accountability. In this respect, there were a lot to be improved in Japanese politics and business. Unfortunately, however, when the bubble burst in the early 1990s causing serious damage to the balance sheets of the government, private corporations and household sector, Japanese failed to see it as a wakeup call for bold reform. Instead, the Japanese wishfully thought that the good old days will come back sooner or later, thus wasting time while avoiding painful restructuring.

It should be fully recognized that the amount of effort needed to carry out reform is truly daunting. It is so precisely because the performance was so successful and therefore acceptance of and trust in the old system was so deeply rooted. The challenge of reform Japan is faced with now is more serious than comparable cases in other developed countries. The plight of the Japanese economy was a combined product of the damage done by the burst of the bubble and the mishandling of the situation due to the delay of structural reform. To a considerable extent, the macro-economic problem and the micro-economic problem have aggravated each other and made the situation more intractable.

Since April last year, under the leadership of Prime Minister Koizumi, Japan started a serious effort to address the problem. Some foreign observers tried to discount the significance of his effort, suggesting cynically that he was the fourth or fifth Prime Minister during the last ten years who advocated reform of Japan. This is not fair for two reasons. First, Koizumi was the first Prime Minister who understands that the real reform of Japan cannot be complete without reform of political institutions. Second, he was the first Prime Minister who presented a concrete reform agenda in a comprehensive framework. Nevertheless, Koizumi is now facing an increasingly louder voice of disappointment, frustration and criticism from both inside and outside the country. Indeed, many of the reform items on his agenda are still half-cooked. Politicians, media, and academics are complaining about his lack of leadership, skill, and consistency. Some even argue that his days are already counted. The present climate is certainly not particularly favorable for him.

I am one, however, who would argue that the gloomy scenario is not at all convincing. There are three reasons. First, in spite of all these adverse winds, Koizumi himself is totally unshaken. He is as firm as ever in his determination to carry out the job. Second, his achievement so far, although admittedly incomplete, is quite significant. On major reform items on the agenda, such as the elimination of political parties' undue influence on the policy making process, privatization of inefficient quasi-governmental corporations,

reduction of wasteful public works, reform of the tax system, reform of social security, and reform of local government finance, Koizumi has successfully established important beachheads from which he will advance further reform. Third, there is no contender now, either in his own party or in opposition parties, who can possibly replace him as Prime Minister. It is my hunch that he has a fair chance to stay in his job so that he can score more wins in his reform exercise.

The macro economic situation does not warrant premature optimism. There are certainly increasing signs of recovery in consumption, production and investment supported by the improved prospect of corporate earnings. If the recovery of the US economy is reassured, the Japanese recovery will also become firmer. However, there are still several underlying problems that need to be addressed aggressively. The first is public debt. The level of the government's debt at 140% of GDP is clearly unsustainable. The steps to improve the situation are first to contain the expansion of expenditures within the growth of GDP, thereby reducing the deficit. The second step is to restore the primary surplus of the budget by 2010. I argue that Japan's fiscal deficit problem is serious, and its solution will be a long haul. At the same time, there is no risk of fiscal disruption. All debt is denominated in yen and 95% of it is held by Japanese citizens. Japanese households possess twice as much financial assets as the government's debt.

The second problem is bad assets held by banks. The government and the banks must bear the blame for having delayed decisive solution of the problem for too long. It was as late as last year when they really seriously set their minds to it. Significant progress is now being made and in two years time I believe the situation will become manageable.

The third problem is in the corporate sector. The Japanese corporate sector has been a clear case of dichotomy. On the one side, there is a group of manufacturing and service companies that are highly competitive internationally because of high quality of products and good business models. On the other side, however, there are distribution, construction, real estate and other domestic market-oriented industries that were inefficient and uncompetitive but were able to survive only because of regulation and protection by the government. They were the companies that accumulated excessive debt, equipment and employment and became major culprit of the bad assets of banks. Now these industries are thrown into a heavy storm of restructuring prompted by the market forces and foreign competition. The streamlining of these industries is a key to enhancing the competitiveness

of the Japanese economy as a whole.

The fourth problem is the oversaving of the household sector. Japanese households need to be encouraged to consume more and invest more. It is understandable that, against the backdrop of an aging population and the lackluster business performance, people are tempted to put their money in savings account. In addition to the improvement of the general economic climate, Japan needs to provide an investor-friendly capital market and attractive goods and services for consumers.

All in all, there are a host of challenges for the Japanese economy. I may summarize my observations as follows: macro and micro area problems with the Japanese economy are critical and pressing, and efforts of Koizumi administration are enduring a rough ride against resistance and sabotage by vested interest groups. Yet, progress is being made steadily on most fronts, though not as speedily as some have hoped. It will take another two or three years for Japan to be able to declare that it is out of the woods.

Well, everybody has worries and hopes. Even mighty America is in a state of suspense. The September 11 attack and Enron scandal dealt a serious blow to the perception of invincible strength of American society and American market. The trauma will not go away easily. The suspicious mood spread quickly to other parts of the world. In spite of the seeming recovery of the American economy, stock markets around the world are tottering through the path of agonizing reappraisal. What Enron scandal and its followers brought about was the loss of trust in the integrity and the ability of self-correction of big corporations, which until recently were viewed as the banner bearers of the triumphant capitalist market.

It is saddening to discover that in all cases of misconduct, the ultimate culprit is personal financial greed. The series of scandals have mercilessly reconfirmed that it is a matter of the gene of the capitalist market. Here we find ourselves in a serious dilemma. On the one hand it is absolutely clear that the relentless pursuit of maximum profit is the ultimate source of dynamism that keeps the capitalist market moving. At the same time, greed, like a cancer, destroys the sound functioning of the market. Naturally, the American market must face the dilemma most squarely. However, Asia cannot and should not remain indifferent to the dilemma of the American market. Asians must recognize fully that the real source of resilience of the Anglo-Saxon market was the ability stored in the market itself to conduct thorough self-reflection and to take self-corrective measures. In other words, the

most reliable guardian of the market is not the powerful official regulators or charismatic business leaders, but the readiness and willingness of society to reflect upon how best to make economic development and human integrity compatible with each other. It is the strength of an open and matured society.

Asia has achieved phenomenal economic development since the 1970s. Strong aspiration for development shared by both government and citizens, massive inflow of foreign capital and technology, and dynamic entrepreneurship have made it happen. Inevitably, however, the shining success has a dark side. All kinds of misconducts, including fraud, bribery, and embezzlement, are rampant in most Asian countries. Although governments are ostensibly trying hard to reduce the misconduct, there is little sign of genuine and spontaneous response from society itself urging a serious reflection on the problem. If Asia wishes to become a pole on the globe alongside with North America and Europe, I believe it is crucially important to develop a society and a market that respect trust as the highest value and that do not hesitate to admit its own defects and to initiate actions of self-correction. It is particularly important now when the immaculate image of the American market is badly tarnished. It will take some time to restore the confidence, but American society will surely try its best to overcome the challenge.

Asia too must continue to change, and I believe it will.

(This paper is a record of the speech given to Asia Sun Dance Conference hosted by Goldman Sachs Group, Inc. on 24th June 2002 in Seoul.)

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