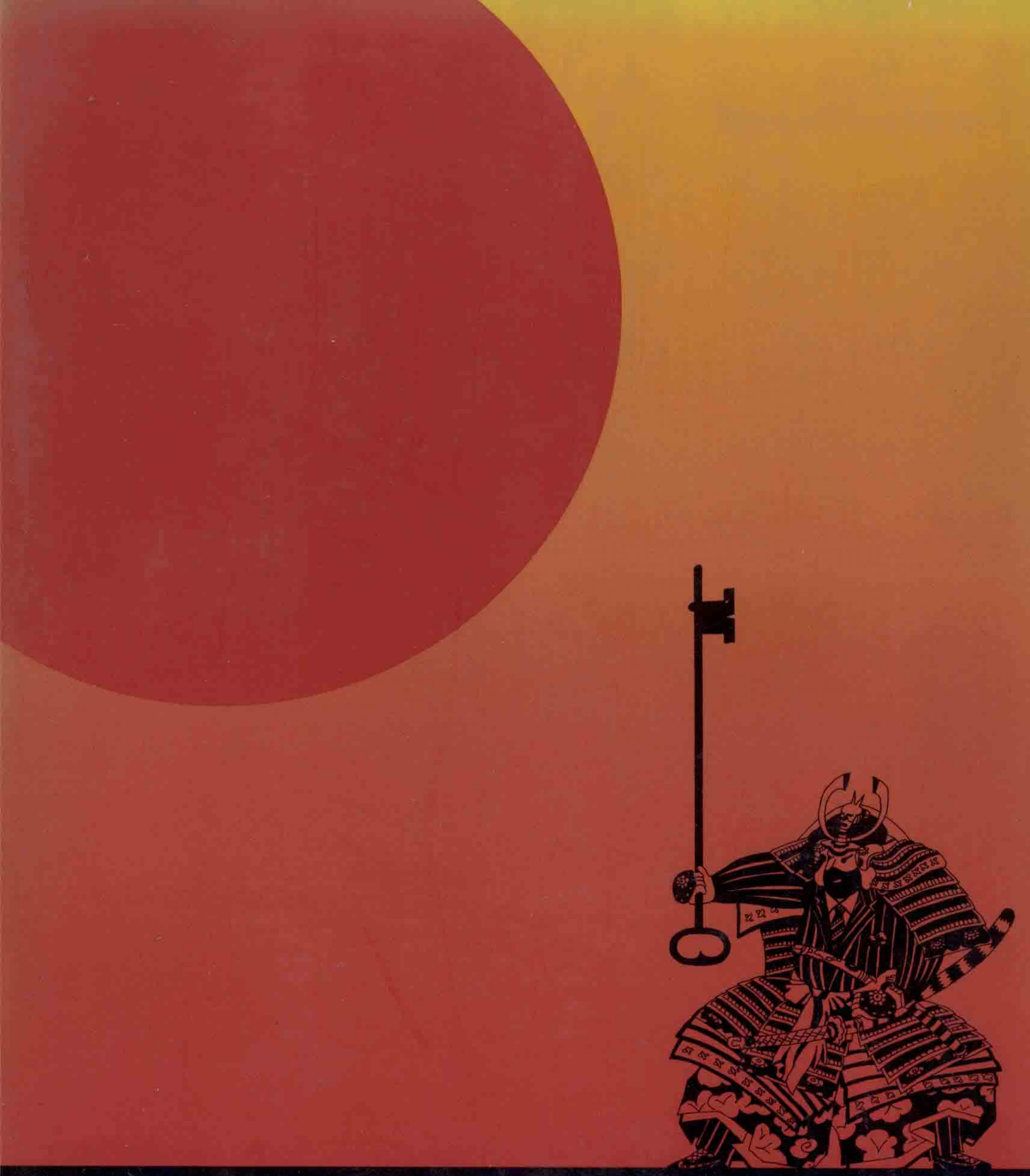

UNLOCKING THE BUREAUCRAT'S KINGDOM

DEREGULATION AND THE JAPANESE ECONOMY

Frank Gibney
Editor

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Foreword

THROUGHOUT MY TENURE as ambassador to Japan (1989–93) I was obliged to spend much of my time wrestling with bilateral trade problems between Washington and Tokyo. The most vexing and intractable barriers to Japan's market seemed frequently to be embedded in a regulatory system that was extensive, opaque, and often arbitrary—particularly for new entrants to the market. The Bush administration's Structural Impediments Initiative (SII) negotiations were directed toward removing or modifying a number of these regulatory barriers to trade.

Recognizing that requests for change had little prospect of success if they bore a "made in U.S.A." label, we shopped around for reforms proposed by thoughtful and knowledgeable Japanese. We had no difficulty assembling a wide range of recommendations from the Maekawa Commission, the Administrative Reform Council, and various academicians. Some of their proposals were designed to foster greater competition by lowering market entry barriers, some to enhance the clout of the Fair Trade Commission, some to make keiretsu networks more transparent and less exclusive, and some to lower prices and expand the choices available to Japanese consumers. In making the case for these proposals the U.S. Embassy consistently underlined the potential benefits of reform to the Japanese people. This perhaps accounts for the fact that despite a delicate and difficult negotiation, the results were generally applauded by the Japanese press—and even a few politicians. Some of the practical results were laudable, for example, amendment of the Large Retail Store Law. But the bargaining left a sour aftertaste on the Japanese side, and following President Clinton's election in 1992, Washington adopted a different approach to trade negotiations with Tokyo.

In recent years the political environment in Japan for regulatory reform has changed. In the wake of a prolonged recession, deregulation is widely heralded in Japan as a necessary prerequisite for reviving the Japanese economy. The Keidanren industrial federation has become an outspoken proponent of reform, as have other elements of the business establishment. The press insistently endorses the need for reform. And prominent politicians—above all, Prime Minister Ryutaro Hashimoto and the opposition leader Ichiro Ozawa—have made administrative reform and deregulation central elements of their party platforms.

Not only have the number of proponents of administrative reform increased, their arguments have changed. The Maekawa Report, issued in the mid-1980s, urged reform in order to mollify foreign critics and to harmonize Japan's industrial structure and business practices with those of its trading partners. Today, deregulation is promoted as a means of enhancing Japan's future growth prospects, preserving the competitiveness of its industry, and improving the welfare of its long-suffering consumers. Clearly, these are arguments that can be presented with greater conviction by Japanese politicians and endorsed with greater enthusiasm by Japanese voters.

The sense of urgency behind efforts to promote administrative reform and deregulation has also intensified. The reasons are obvious. Other policy options for reviving the economy (for example, increased public works spending) were tried but produced disappointing results. As financial markets have gone global, Japan's costly and heavily regulated financial sector has been left behind. And there is a growing awareness within the Japanese establishment that an economy that relies mainly on a strong manufacturing sector is like a bird flying on one wing. With this comes grudging acknowledgment that Japan's service industries in fields like telecommunications, financial services, transportation, construction, electric power, and health care are unlikely to become world class without more direct exposure to international competition in Japan. And the financial crisis in Asia has reinforced the perceived need to step up the pace of reform efforts by highlighting the consequences of lax regulatory arrangements and a lack of disclosure by financial firms.

Yet, while the political climate in Tokyo appears more conducive to administrative reform and deregulation, progress has been slow. The Opposition victory in Lower House elections in 1993 seemed to open the door to change, but the Hosokawa government accorded priority to electoral reform; the Hata government, which replaced it, was very short lived; and the Maruryama coalition regime possessed neither the political strength nor policy conviction to push a regulatory reform agenda forward. To its credit, the Hashimoto government seized the issue, promised to "fight like a ball of fire" for reform, and put forward in 1997 an ambitious plan for streamlining the state bureaucracy, restructuring the budgetary process, deregulating the financial sector, and promoting wide-ranging changes, *inter alia*, in the social security and education systems. A "big bang" financial system reform bill passed the Diet in 1997, and its implementation will commence in April 1998.

Though announcements are ambitious, and some progress is being made, there have been disappointments as well. Plans to reduce the number of ministries and government agencies have been described by the press as a mere paper shuffle. Proposals to privatize the mail and postal savings and insurance systems have as yet come to naught. A call to hive off the Finance Ministry's monetary and tax policy responsibilities from its budget and spending policy prerogatives was beaten back by the Liberal Democratic Party finance "zoku" members in the Diet. And despite much public criticism, the *amakudari* ("descent from heaven") system of placing former officials in key private sector jobs, thereby preserving a symbiotic connection between regulators and the regulated, remains essentially intact. Hence, the palpable sense that proponents of reform face an uphill battle against formidable resistance.

And so they do. The business community enthusiastically endorses the principle of deregulation, yet does not necessarily welcome changes in those specific administrative practices that inhibit competitors. The political class remains weak, and LDP attitudes toward regulatory reform remain ambivalent. Many of its most influential Diet members derive direct benefits from the current regulatory system; they help companies find their way through a labyrinthine bureaucratic maze, collecting handsome payments along the way for their services. Of course the most resourceful and tenacious resistance comes, predictably, from the bureaucracy itself. It has little incentive fundamentally to alter a system that enables it to manage the Japanese economy, run the day-to-day affairs of government, and thus "call the tune."

In this connection, several of the criteria that have been introduced for evaluating regulatory reform—most notably transparency of the regulatory process and international comparability of regulatory standards—represent a direct threat to cherished bureaucratic prerogatives. The result has been a certain disjunction between the glacial pace of administrative reform efforts and the growing demands for change from the press, from the business elite, and some officials and politicians.

The American government has occasionally attempted to accelerate the pace of change through private or public encouragement. During my time in Tokyo I was often accused of applying excessive "gaiatsu"or "foreign pressure." Hence, I found it singularly ironic that some of the same individuals who criticized my activities in public, privately solicited such outside pressures to reinforce and facilitate their own efforts to foster reforms. By the time I finished my official duties, I concluded that nationalistic reactions against foreign pressure had grown more rapidly than the ability of the Japanese government to successfully undertake reforms without it. Perhaps that, too, has begun to change.

Today, "gaiatsu" is being applied by market forces. And "naiatsu" or "internal pressure" has grown apace. Both are healthy developments. But it is important for American readers of this volume to remember that Japan's regulatory traditions are different than ours, and that reforms, when they come, will not necessarily emulate an "American model." The Japanese public expects and accepts a greater degree of governmental intervention in the economy than we find comfortable. The business community is more accustomed to regarding the government as a partner than as a referee. Informal processes of bureaucratic direction—for example, the tradition of "administrative guidance" and the substantial role played by trade associations in shaping and carrying out bureaucratic directives—are more deeply embedded in Japan's governance process. The cozy, insider connections among Japanese legislators, regulators, and the regulated, have, to be sure, been somewhat attenuated. But they remain unusually intimate by American standards. Indeed this fusion of public and private interests remains at the heart of Japan's highly protected, highly subsidized, and comparatively uncompetitive service sector. Thus, while change is coming, albeit incrementally, the form it takes will often surprise and not infrequently disappoint foreigners.

Nonetheless, market entry is easing, competition is growing, and in the financial sector particularly, the growing staffs of the foreign banks, securities firms, and insurance companies are perhaps the strongest evidence of their high expectations for "big bang" financial reforms.

So it is a time of ferment in Japan that will bring great challenges and large opportunities. I heartily endorse Frank Gibney's call for a "third opening" of Japan. For the sake of the relationship that is critically important to the welfare and security of the American and Japanese people and the stability of Asia, I hope it will be accomplished with some dispatch and largely through Japan's own efforts.

MICHAEL H. ARMACOST
President, Brookings Institution

Preface

THE CHAPTERS in this volume were originally written as part of a joint study of economic overregulation and its remedies first commissioned by the Sasakawa Peace Foundation in 1995. Taking "Reshaping the Japanese Marketplace" as theme and working title, the Pacific Basin Institute and the Mansfield Center for Asia-Pacific Affairs asked a cross-section of Japanese, American, and European authorities on this subject to state the problems caused by bureaucratic overregulation and offer some prescriptive remedies in the bargain. Much had been written on this subject in the Japanese press, but surprisingly few concerted studies had been made. For deregulation, with the lessening of the ministry mandarins' control that it implies, is in a very real sense the hinge that can swing back the now-anachronistic mindset of the "catch-up economy" and bring Japan's nation-society back to political as well as economic health.

In Japan the study was climaxed by a conference held at Keidanren headquarters in Tokyo on March 3, 1996, before a blue-ribbon audience of Japanese business leaders, journalists, and public officials. The original essays in the study were collected in a book, published at that time by Kodansha in Japanese, *Kanryotachi no Taikoku* (The Bureaucrats' Superpower). Given the passage of time, as well as the inevitable problems of translation, I asked almost all of the original contributors to update and revise their papers for this book. What editing that seemed necessary was provided by other members of the Pacific Basin Institute and myself. For developing the theme concept, as well as the work of organizing and managing the 1996 conference, we are indebted to Tovah Ladier, director of the Mansfield Center and Akira Iriyama, president of the Sasakawa Peace Foundation. Shigeki Hijino, Tokyo representative of the Pacific Basin Institute, was also of great help. Particular thanks is owed to our editor, James Gibney, who brought the book to its final form, and to Theresa Walker and her colleagues at the Brookings Institution Press.

Our study was first aimed primarily at the Japanese public, but we believe it will prove equally useful to non-Japanese readers, Americans in particular. A minor but persistent problem in translation and description was presented by the Japanese language itself. As contrasted with the readily adversarial tone of English, the imposed civility of Japanese tends to sugarcoat problems and ease around dilemmas. A variety of misunderstandings in international translation follows. Where English, for example, speaks bluntly of "deregulation," meaning " to get rid of regulations," Japanese uses the phrase "*kisei kanwa*" meaning literally, "to soften regulations." During the various Japanese-American controversies of the Bush administration, for example, American negotiators (and newspaper readers) talked about something called a "structural impediments initiative." By contrast, Japanese negotiators (and newspaper readers) referred to *kozo kyogi*—a phrase which means literally, "conferences about structure."

Part one of this volume offers some historical and cultural perspective on regulatory reform. In Part two the authors consider areas in which the problems of bureaucratic overregulation have been especially acute. Finally, the epilogue offers an overview of Japan's postwar industrial policy. The people who contributed to this study have different backgrounds and offer different perspectives. The views of the political, the economic, and business sectors, as well as journalists, are represented. Their points of view often diverge. No editorial attempt has been made to homogenize them. Some have dealt with the history of government controls in Japan; others have described its workings. Some write with indignation; others are more detached. At least one contributor makes the case for continued regulation and bureaucratic guidance. But all the authors share a concern with the overriding problem, and most strongly advocate the need for change. By highlighting the inequities in the Japanese economic framework, the authors hope in general to show how outmoded such practices have become, how damaging they can be to Japanese consumers and producers, and, finally, how incompatible they are with Japan's stature as a world economic power in a globalized economy.

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Introduction

Frank Gibney

> *A spectre is haunting Japan—the spectre of international capitalism.*
>
> —with apologies to Karl Marx

WHEN PEOPLE TALKED of a new "Pacific century" for the Asia Pacific nations, Japan was assumed to be the original role model. With more than four trillion dollars in gross national product, a favorable trade balance that in 1996 exceeded $120 billion, exports amounting to 10 percent of the world total, and productivity figures in seemingly unending ascension, Japan, standing at the edge of the twenty-first century, continues to dominate the statistics. The People's Republic of China has experienced explosive growth, and what the World Bank has christened HPAEs (high-performing Asian economies) continue to make progress, yet Japan is rightly given credit for pointing the way with its growth-oriented public policies. Scholars and journalists, commenting on the rise of popular democracy and an Asian middle class, cite postwar Japan as the great exemplar.

Yet here, at the assumed apogee of their modern history, the people who built the "economic miracle" of the late twentieth century remain caught in the toils of a seven-year-old slump. With Japan's government still a shaky coalition of warring factions, real political leadership has yet to reappear. A bureaucratic establishment once widely regarded as next to omniscient has shown itself unwilling and probably incapable of making significant reforms or changes in the nation's course, politicians' pious statements to the contrary. To complicate Japan's domestic problems a sudden and drastic fall in stock market and currency values, set off by the virtual collapse of Thailand's economy in early summer, had spread by October 1997 through most of the hitherto booming HPAEs in Southeast Asia and Korea. With its strong currency reserves, extensive trading, and heavy investments throughout the region, Japan might have been expected to offer heavy economic support in this crisis—much as the United States had intervened two years ago to forestall a similar breakdown in Mexico's economy. Given Japan's own difficulties, however, supportive action from Tokyo seemed hardly possible. A commentary in the *Economist* on November 15, 1997, noted: "Far from being the answer, Japan is part of the region's current problems." As of November 1997, Japanese banks had lavished close to $300 billion worth of loans on other Asian economies.

The Japanese public, while still proud of recent achievement, is confused and uncertain. The November 1996 elections—with a 60 percent voter turnout, the lowest in Japan's postwar history— reflected the growing apathy of voters alienated to the point of anomie. The hustling, internationally ambitious Japanese businessman, so long the hero of economic case studies, is worriedly facing basic dilemmas—overproduction, underemployment, and the flight of jobs offshore among them—that, caught in the euphoria of past successes, he never thought would occur. Despite heavy government support, the Japanese Dow in 1997 hovers at less than one-half what prices were in the heyday of the 1980s' "bubble" economy. Once-eager foreign investors are hard to find. The pessimistic refrain of "*Nihon uri*—sell Japan" is widely quoted. It epitomizes a national crisis of confidence.

This crisis of confidence has at last exposed the basic contradiction lurking behind the decades of "Japan Inc.'s" high-growth progress. On the one hand, we have had the spectacle of the world's hardest-fighting competitors, vying for market share and profits in the best traditions of capitalist free enterprise. On the other, we have the world's most powerful bureaucrats, regulating economy and polity with a heavy thicket of regulation, guidance, and injunction worthy of the eighteenth-century Tokugawa shogunate's ministers (whose spiritual descendants they are).

The contradiction here has been obvious to all, yet the Japanese have never been overmuch bothered by logical contradictions. The coexistence of competitive private enterprise and public control seemed practical and useful. It worked. It worked, however, only so long as both parties to the contradiction cooperated in a headlong drive, led by selective exports, to catch up with the industrialized West. The drive proved a success, but success was transitory. Paradoxically, the more its brilliant business strategies put Japan at the top of the world's economy, the more the problems in the contradiction began to surface.

For all the brilliance and energy of Japan's postwar economic miracle, the interlocking of business and bureaucracy, with the latter originally in charge, led to a dominion of entrenched interests which makes a mockery of the free enterprise that Japanese spokesmen publicly support. Time and again newcomers to the Japanese market, especially if they are foreigners, have run up against layer upon layer of detailed government regulation designed to support the status quo. Established companies have combined in *keiretsu* groups and powerful trade associations that actually work in restraint of trade. Japan has also perpetuated a kind of "cultural protectionism," which has if anything intensified over the years. Its proponents, widely supported by the public, insist that the Japanese are so different "culturally" from others that only purposefully designed home-grown products and services can satisfy their wants and concerns.

Since the Meiji Restoration the growth of the Japanese economy has been accomplished within the context of the so-called capitalist development state. At its best, this construct represented a triumph of economic innovation.[1] It is irresponsible exaggeration to dismiss the Japanese achievement as the forced lockstep march of something called "Japan, Inc." Free-enterprise competition within Japan is if anything more intense than in the other leading capitalist economies. Nonetheless, capital and labor alike have worked within the framework of a tightly meshed industrial policy. Theirs has been a competition fought out in Japan, within a set of firmly determined ground rules.[2] These rules and regulations cover every aspect of the national life. They are made and enforced by the consistent guidance of a highly concerned government bureaucracy, which has made its support of Japanese business internationally a canon of public policy.

Until recently, at least, Japan's "producer-first" economy has been equally supported by an exceptionally docile consumer population. Japan's consumers were accustomed to paying high prices for locally made products that sold far more cheaply in international markets. Content as they were, however, to submerge personal gain and comfort in the long-range goals of national and corporate interest, they were willing accomplices in the success of the original modern supply siders.

Within the last few years, however, this mindset has been changing. Japan's business leaders have come to realize that the catch-up drives of a capitalist development state are no longer necessary or useful to the world's second-largest economic power in an era in which free international trade and investment have become imperatives even beyond the power of influential national finance ministries to control. Shoichiro Toyoda, the chairman of the Keidanren (and, it should be added, of the Toyota group), has repeatedly underscored the urgency, as he emphasized, "of bold and effective measures to stimulate domestic demand and open Japan's markets. . . . We simply cannot leave reform half-done." [3]

Toward the 'Third Opening' of Japan

Keidanren, the abbreviated Japanese name for the Japan Federation of Business Organizations, is the powerful official spokesman for Japanese big business. Until the mid-1990s, it was also the principal contributor to Japan's majority Liberal Democratic Party. Most recently, in a January 1997 statement, Keidanren summarized no less than 886 separate requests to the government for administrative deregulation throughout the economy. By way of punctuating its chairman's comments, a Keidanren White Paper demanded deregulation, "the linchpin of economic reform," in almost every business field. The implications of its report were clear. Japan can raise productivity and cure its ailing economy only by getting the bureaucracy out of business, thereby enforcing "urgent and drastic reform of the economic structure."[4]

The concern of Japan's business leadership arises not merely from the recession fall-off in consumer demand. The recent successes of emerging supermarkets and cut-rate retail enterprises in Japan bear witness to a new price consciousness among Japanese consumers. They are beginning to behave less like props in a stage-managed economy and more like cost-conscious (and volatile) consumers in other countries.

But before Japan can normalize the domestic side of its now internationalized economy, Japanese voters must understand the extent to which the processes of trade and investment in their country are clipped and truncated by excessive government regulation and barely visible collusion among business, bureaucracy, and often the media. Ubiquitous government regulation inside Japan fostered an overprotected "hothouse economy," insulated from the pushes and pulls of world economic forces. As Japan became one of the world's economic powers, however, with its favorable trade balances swollen and its financial sector at least partly liberalized, the hothouse windows began to break. Foreign trading partners ever more stridently demanded equal rights for their own products to be sold in Japan. Japanese consumers themselves, as they traveled around the world, began to realize that they were paying almost twice as much for most basic consumer goods as the people outside. The need for Japan to become a "normal country," as the opposition *Shinshinto* (New Frontier Party) leader Ichiro Ozawa put it, is thus as compelling in the economic sphere as in the political.

Belatedly, the government has come to acknowledge the problem. In his Diet message of January 1997, Prime Minister Ryutaro Hashimoto promised a comprehensive review of "all administrative areas, without exception." "It is clear," he conceded, "that the current framework (structure) is an obstacle to the vigorous development of this nation. . . . The present system is hindering Japan's development at a time when the world is being integrated, allowing increasing freedom in the movement of people, goods, wages, and information across borders." Having already promised a "Big Bang" package to deregulate a financial system still hopelessly dominated by Finance Ministry bureaucrats, Hashimoto vowed to put teeth in the sweeping Deregulation Action Program first advanced in 1995. But he added a cautious warning: "Changing systems that are deeply rooted in our society will only happen with great difficulty."[5]

Reaction to his statement was predictably skeptical. In an editorial published the following day, the *Mainichi Shimbun* tartly compared the prime minister's objectives with the vagueness of his plans for achieving them—not to mention the conventional political pork-barreling in his 1997 budget. "We would like to believe for the time being that the Prime Minister is 'serious,' " the editorial concluded. "Hashimoto has nowhere to go but ahead."[6]

After a year of highly publicized planning activity, however, the Big Bang—named after the sweeping financial deregulation of the London City establishment a decade ago—seems rather hard to ignite. In September 1997, the Liberal Democratic Party, back in control of the Diet's Lower House for the first time since 1993, reelected Hashimoto as party president and hence prime minister. New laws and procedures have in-