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**Article**

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## Japan: How to Overcome the Difficult Decade?

### Editorial

By Mechthild Schrooten\*

Japan's overwhelming success story came to a sudden end when the bubble burst in the 80s. Since then, the economy has been suffering from different diseases that all find their expression in decreasing domestic demand. What brought about the downturn? Was it the bubble burst itself that raised uncertainty over the country's future economic development? Was it the over-investment of the last years, or the specific Japanese saving culture? Until recently, a precise diagnosis of the factors behind this phenomenon has been lacking. Consequently the case of Japan's economic rise and fall has posed a challenge for many economists. Not only the weak performance of the world's second-largest economy is puzzling, but also the more or less unsuccessful policy answers that have been put forward. During the last ten years different policy measures went into effect, affecting nearly all parts of the economy. However, stagnation continued. Therefore, the last decade is often called Japan's difficult decade. Furthermore, a far-reaching and more general question arose: Is domestic economic policy counterproductive in a globalized world? Does Japan provide the first prominent example of a new trend in this direction?

This volume of the DIW Berlin's *Vierteljahrshefte* seeks to contribute to the current debate on Japan's economic chances, limits and future scenarios. It brings together diverse views on the Japanese economy, on the ongoing transition process and on the evaluation of future prospects. We start with a look at the overall economic development in Japan during the nineties. *Günther Weinert* from the *HWWA* (Hamburg Institute of International Economics) analyzes macroeconomic factors behind the economic slowdown in the 90s. His focus lies on the analysis of changes in demand behavior. He arrives at the conclusion that the most remarkable change took place in private investment behavior, which became extremely volatile. Taking into account that macroeconomic policies might function as a stabilizer for economic growth perspectives, Weinert evaluates Japanese fiscal and monetary policy. He concludes that one can at least say that neither monetary nor fiscal policy hampered economic

recovery. In sum, however, macroeconomic policy was not able to deal with the adverse effects arising from structural problems.

While the domestic economy was and is suffering from weak private demand, it is interesting to ask how exports were and are promoted. To analyze Japan's integration into international markets, *Jörn Kleinert* from the *Kiel Institute for World Economics* uses indicators such as trade openness, intra-industry trade intensity, Feldstein-Horioka coefficients, royalties and license fee flows, and outward production ratios. He comes to the conclusion that despite the impressive increase of cross-border capital flows that characterized the last century, Japan's international integration remains relatively low. However, in the 90s, the level and structure of Japanese international economic relationships changed and became increasingly similar to those of other OECD countries. This finding holds for trade as well as for capital and knowledge flows. Nevertheless he finds that the Japanese progress in globalization made in the 1980s has been consolidated but not expanded remarkably in the 1990s.

What are the factors behind the yen/USD exchange rate? This is the question raised by *Gunther Schnabl* from the *University of Tübingen* and the *University of Stanford*. In his paper he focuses on the influence of interest rates, prices and foreign exchange policy on the yen-dollar exchange rate. *Schnabl* finds that real interest differentials can only explain short-term exchange rate changes. Since prices have been exerting a major influence on the Japanese currency in the long run, *Schnabl* holds deflation responsible for the "high" yen. He reflects on the links between the expansionary monetary policy and unsterilized foreign exchange purchases. Both are closely connected and their combination might be an interesting remedy to overcome the recent deflation. However, as *Schnabl* concludes, the future direction of Japanese foreign exchange policy remains uncertain.

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*Andreas Nabor* from the *HWWA* (Hamburg Institute of International Economics) analyzes Japan's ambitious financial reform program. The article focuses on the gap between design and implementation of the far-reaching reforms. Nabor explains that five years after the implementation of the "Big Bang", the country seems to have made much more headway in its long-term plan than in its short-term goal. In particular, structural problems such as the non-performing loan problem, still remain unsolved and will hamper future development. He argues that to further strengthen competition, the government should push the privatization of public and semi-public financial organizations.

*Mechthild Schrooten* from the *DIW Berlin* combines findings from New Institutional Economics with those of endogenous growth theory to explain Japan's difficulties in gaining efficiency from the international integration of the financial sector. In general, economic theory sees international financial market integration as an important instrument for increasing economic productivity. But what happened to Japan? Financial sector reforms focus on the adoption of international rules and law for the domestic banking sector. However, underpinning "imported" law with domestic internal institutions seems to be difficult: often these new rules neglect traditional Japanese financial market characteristics such as the importance of personal relationships. These tensions between the legal framework and the rules of the game within the society might even increase inefficiencies within the financial sector — against this background, the near-term economic perspectives look relatively dim.

*Martin Schulz* from *Fujitsu Research Institute Tokyo* analyzes the ongoing changes in corporate governance regimes. He explains the stakeholder system, which is often considered as a major factor behind the Japanese success story up to the 1980s. According to the requirements of a highly complex economy, Japan is currently moving toward a shareholder system which brings with it "outsider" control of enterprise decisions. *Schulz* focuses on the factors which make it so difficult to implement a successful turnaround in corporate governance. He finds that during the last two decades, a confusing incentive structure at the very least hampered the necessary transformation process. Nevertheless, transformation itself is underway and widely accepted. Therefore — as regards the changes in corporate control — the 1990s cannot simply be called a difficult decade. However, it will still take some time for these changes to bring about the expected positive results concerning efficiency gains in the enterprise sector.

*Hilda Joffe* from the *Free University Berlin* analyses a specific segment of the Japanese economy: the Internet market. She starts by presenting a prominent study on Internet usage which concludes that Japan is lagging at

least two years behind the US. *Joffe* explains that Internet usage and e-commerce follow different patterns in Japan than in the rest of the world. While Internet usage and electronic commerce are PC-concentrated in most parts of the world, in Japan, they are promoted mainly by mobile phones and convenience stores. Furthermore, mobile wireless Internet plays a major role in Japanese daily life and has positive spillover effects on the country's overall infrastructure. *Joffe* describes the importance of convenience stores with regard to B2C e-commerce, in their role as payment and distribution centers and as Internet access points through multimedia terminals. She concludes that in contrast to the study mentioned above, the last decade can be considered successful concerning Internet usage and e-commerce in Japan. Additionally, an expansion of Japanese-type e-commerce and Internet usage to other Southeast Asian countries, where urban structures are similar to those in Japan, is likely.

*Tetsuo Fukawa* from the *National Institute of Population and Social Security Research, Tokyo (IPSS)* analyses welfare state reform in 1990s. He discusses the similarities and differences between Japan and Germany in the implementation of three major policy areas: public pension reform, health care reform and introduction of long-term care insurance. He starts with the observation that in both countries, recent reform steps have the same goals: financing the welfare system against the background of a rapidly ageing population. Both countries are currently reviewing new options that include finding new approaches to the needs of the elderly, and broadening the financing basis of social benefits. Fukawa sees a strong impact of German reform measures on Japanese reform debates.

As is evidenced in these short descriptions, the papers presented here cover a wide range of topics: from macroeconomic policy through international integration to such structural problems as changes in corporate governance and social security issues. The papers touch on key problems of the Japanese economy during the last ten years and try to answer the question whether the last decade was really a difficult decade for Japan. And the unanimous answer seems to be: indeed, the last decade was an extremely difficult one. A lot of different reforms were initiated. Nevertheless, in the end, the Japanese economy did not revert back to its pre-crisis level of performance. The future will therefore be challenging. Since Japan is suffering from an unconventional form of economic's crisis — which is reflected by deflation — unconventional policy measures might help overcome the recent recession. However, the future prospects of the Japanese economy seem to depend heavily not only on the speed of implementation of reforms, but also on the harmonization of the reform steps in different areas such as financial markets, the enterprise sector and the incentive structure given by the macroeconomic policy.

The idea to bring together different views on the Japanese reform process was born during a conference in the *Japanisch-Deutsches Zentrum*, Berlin. Since then many helpful discussions have taken place — and this volume of DIW Berlin's *Vierteljahrshefte* is the result. In preparing it I benefited greatly from *Harald Trabold's* editorial experience. The technical assistance was provided efficiently

and patiently by Ellen Müller-Gödtel. Deborah Bowen and Louisa Smith supported the authors by providing a language check. I am grateful the proofreaders at the DIW Berlin who made comments on the drafts of the articles. Finally, I thank the authors for the interesting papers they have contributed.