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Japan's "Economic Miracle": What Happened?

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Japan's "Economic Miracle": What Happened?

Summary

What happened to Japan's "economic miracle?" Since the 1990s, Japan has been experiencing slow economic growth, income contraction, and recession along with high unemployment and other problems. These trends since the 1990s compare starkly with the 1970s and 1980s, when Japan's rapid economic growth and development drew admiration from much of the world, including many in the United States, and thrust Japan into the elite club of major industrialized countries. Japan even became established in the minds of some as a model for economic growth and development for other economies to follow, particularly those in East Asia. But Japan's difficulties have cast a cloud over its economic prospects and tarnished, perhaps unnecessarily so, its image as a leading economic power in Asia and the world.

Economic conditions in Japan are having a major impact on U.S.-Japan economic relations and on the overall U.S.-Japan relationship. A strong and stable Japanese economy is important to the United States and the world. Japan is the second largest industrialized economy in the world. If Japan's economy continues to grow slowly or contract, U.S. exports to Japan would probably continue to decline, creating problems for U.S. exporters trying to build a market there. A stagnant or contracting Japanese economy diminishes overall world economic growth and world income.

In the long-term repairing Japan's economic difficulties may present the United States with significant opportunities. Many of the structural problems that some experts have cited as a cause of Japan's less than stellar growth have also been impediments to U.S. exports and investments in Japan and the source of much friction between the two countries. If Japan can successfully address these structural problems, it would likely improve market access in Japan and help alleviate the bilateral trade and investment friction.

As important as Japan's economy is to the United States, the direct policy influence the United States can have on the Japanese economy is limited. Japan's economic problems are a function of its own macroeconomic policies and structural deficiencies. Decisions on these issues are within the purview of the Japanese government.

The United States, including the Congress, can press Japan to pursue macroeconomic policies and microeconomic measures that will lead to sustained economic growth. In the end, the best U.S. defense against continued economic stagnation in Japan will be maintaining U.S. economic strength. This report will be updated as events in Japan continue to evolve.

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Japan's "Economic Miracle": What Happened?

What happened to the Japanese "economic miracle?" Since the beginning of the 1990s, Japan has been experiencing slow economic growth or , at times, recession accompanied by rising unemployment and other problems.. These trends compare starkly with the 1970s and 1980s, when Japan's rapid economic growth and development drew admiration from much of the world, including many in the United States, and thrust Japan into the elite club of major industrialized countries. Japan even became established in the minds of some as a model for economic growth and development for other economies to follow. But Japan's difficulties have cast a cloud over its economic prospects and have tarnished its image as a leading economic power in Asia and the world.

Japan's economic problems and prospects have broad implications for the United States and the world as a whole. The problems emerged and grew as economic crises hit economies in East Asia, Russia, and Latin America. Japan's economic difficulties reignited tensions with the United States as the U.S. trade deficit has soared and have raised concerns in the United States and elsewhere about the likely brake they would have on economic growth in this country and the world as a whole.

The economic problems in Japan have been the subject of legislation and Congressional hearings. They remain of interest to the 107th Congress as the U.S. trade deficit with Japan grows and as some U.S. industries are adversely affected.

This report examines recent economic trends in Japan that paint a picture of a very difficult economic and financial situation and reviews the main factors that have contributed to it. It examines the impact of the crisis on the U.S. economy and on U.S.-Japan economic ties and presents the options available to U.S. policymakers to protect U.S. interests. Events in Japan are evolving. This report will be updated as warranted.

Key Conclusions

The Japan's economic performance remains poor. It suffers from very low or negative growth, deflation, and rising unemployment, and its prospects do not seem to be very positive. Furthermore, it is unlikely to get much external help from the United States or Europe as they are also facing slow growth. Japan also faces a burgeoning debt burden.

The causes of Japan's economic problems are varied and complex. They are rooted in some immediate factors: the burst of the assets bubble in the early 1990s and Japanese government macroeconomic policies that immediately precipitated the crisis.

But they are also rooted in the fundamental structure of the Japanese economy — the complex web of government regulations and business conglomerates.

Of critical importance is Japan's banking sector. The burst of the asset bubble left Japan's private banks holding trillions of yen in non-performing and troubling loans. For the past 25 years, successive Japanese governments have used fiscal and monetary stimulus and have proposed economic restructuring programs with limited success.

The Koizumi government has proposed its own program centered on fiscal discipline and banking reform. The program faces the challenge of trying to maintain fiscal restraint and to encourage banks to dispose of bad loans at a time of global economic slowdown. Koizumi also faces the resistence of entrenched economic interests that have undermined previous economic reform efforts.

Japan's economic future has major implications for the United States. It is a major trading partner and the second largest global economic power. Yet, U.S. influence on Japanese economic policy is limited and is primarily confined to diplomatic pressure. In the end, the best defense against a troubled Japanese economy will probably be a strong U.S. economy.

Trends in the Japanese Economy: Examining the Indicators

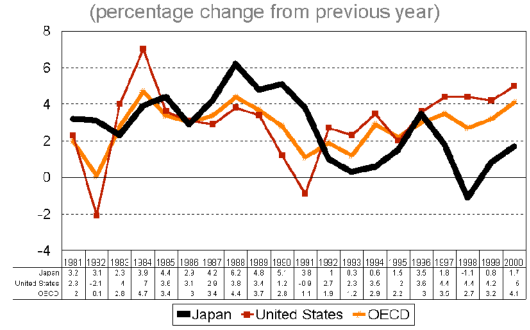
The image of the Japanese economy in the United States, around the world, and within Japan itself has changed many times in the post-war period. From the 1950s to the 1960s, Japan was viewed as a poor but advancing economy relying on the production of labor-intensive goods to drive its re-industrialization. In the 1970s and especially in the 1980s, Japan developed into the world's second largest, and a fully industrialized, economy, on track to overtake the United States as the leading economy in the world. Its success in the production of autos, computers, and other sophisticated goods, its high growth rates, and the rapidly increasing Japanese standard of living helped form this image. Some observers even viewed Japanese economic policies and structure as the "model" to be emulated (and it often was) by other East Asian economies.

But that popular image of Japan has changed almost 180 degrees since the 1990s, as Japan has undergone various difficulties highlighted by slow, and at times negative, economic growth rates. As with many popular images, both the positive and negative ones of Japan have been somewhat exaggerated. Japan was never an invincible economic juggernaut as some writers viewed it in the 1980s, nor is it now a collapsed economy. Nevertheless, most experts would argue that Japan faces both near and long- term challenges that call for bold policies.

Japan's GDP Growth Rates

Figure 1. Japan's GDP Real Growth Rates, 1981-2000

(percentage change from previous year)



	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Japan	3.2	3.1	2.3	3.9	4.4	2.9	4.2	6.2	4.8	5.1	3.8	1	0.3	0.6	1.5	3.5	1.8	-1.1	0.8	1.7
United States	2.3	-2.1	4	7	3.6	3.1	2.9	3.8	3.4	1.2	-0.9	2.7	2.3	3.5	2	3.6	4.4	4.4	4.2	5
OECD	2	0.1	2.8	4.7	3.4	3	3.4	4.4	3.7	2.8	1.1	1.9	1.2	2.9	2.2	3	3.5	2.7	3.2	4.1

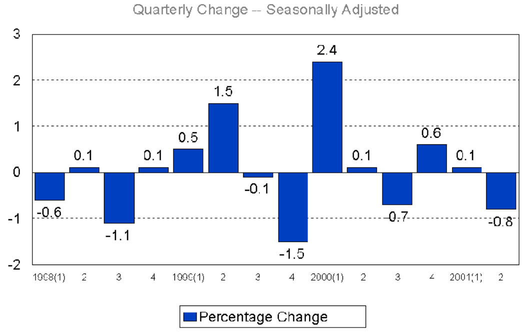
Source:CRS based on OECD data.

Japan experienced impressive, though declining, economic growth rates in the post-war era. From 1960-1970, Japan averaged an annual real (adjusted for inflation) GDP growth rate of 11.0%; from 1970-1980— 5.4%; and 1980-1990— 4.1%. Most economists argue that declining average economic growth rates are commensurate with a maturing economy.[1] Despite the declining trend, Japan's economic growth rates remained on average above those of the United States and the other industrialized countries of the Organization for Economic Cooperation and Development (OECD).[2]

Economic growth trends for Japan since the 1990s have declined markedly, raising concerns both in and outside Japan. From 1991-2000, Japan's real GDP grew on average 1.4%, substantially below previous trends and, as the graph in figure 1 indicates, below U.S. and OECD trends. Since 1991, the growth rate has not exceeded 2% except in the anomalous year of 1996 when it grew 3.5%.

Figure 2. Japan Real GDP Growth Rates, 1998-2001

Quarterly Change -- Seasonally Adjusted



Source: Economic Planning Agency (Japan)

That graph in figure 2 shows quarterly seasonally adjusted GDP growth rates since 1998. It shows that Japan has experienced negative growth six of the last fourteen quarters. Over time, slow or negative growth undermines business and consumer confidence in the economy and diminishes residents' standard of living. Poor economic growth can eventually undermine confidence in political leadership.

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[1]CRS calculations based on data in OECD Economic Outlook 64 December 1998. p.191. As economies develop they are able to import technology from more advanced countries. Investment in these technologies allow less advanced economies to develop and grow rapidly. But as they become more mature, the stock of available technology diminishes as countries must innovate, a longer and more expensive process.

[2]The OECD is a group of the 29 most industrialized economies, including the United States and Japan.

Unemployment

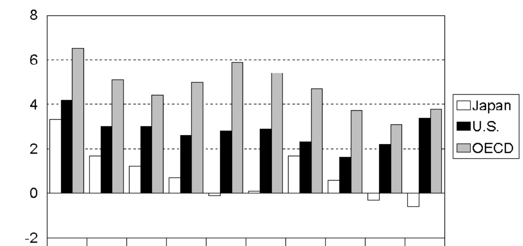
Japan's anemic economy has led to growing unemployment, a relatively new problem in recent Japanese history. Recently, Japan's unemployment rate has exceeded that of the United States, although it has remained below those of most West European countries and the OECD average. From 1981-1990, Japan had an annual average unemployment rate of 2.5% compared to 7.1% for the United States.[3] But Japan's unemployment rate has increased steadily since the 1990s. As of July 2001, it had reached 5.0%, a record for post-World War II Japan.[4]

Standard of Living

Japan has incurred low inflation rates, much lower than rates in the United States and OECD countries as a whole. In fact, Japan now faces a problem of prolonged deflation–negative rates of change in price levels. Extended periods of deflation can be a problem for an economy because declining asset prices discourage investment. Figure 3 depicts Japanese inflation rates compared with the United States and the OECD countries as a whole from 1991 to 2000.

Figure 3. Inflation Rates: Japan, U.S. and OECD

Changes in Consumer Prices, 1991-2000



	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Japan	3.3	1.7	1.2	0.7	-0.1	0.1	1.7	0.6	-0.3	-0.6
U.S.	4.2	3	3	2.6	2.8	2.9	2.3	1.6	2.2	3.4
OECD	6.5	5.1	4.4	5	5.9	5.4	4.7	3.7	3.1	3.8

Source: CRS Based on OECD Data

Despite its economic problems, Japan remains one of the wealthiest countries in the world whose citizens enjoy one of the highest standards of living. Japanese citizens enjoy one of the world's highest per capita/GDP rates. In 2000, it was nominally $36,300 compared with $36,000 for the United States. Measured using purchasing power parity (PPP) — which takes into account exchange rate and cost of living differences — Japan's per capita GDP was below that of the United States — $25,600 compared to $36,000 — but still above that of many other industrialized economies.[5] Japanese citizens pay much higher prices for housing, fuel, food and other staples than do U.S. citizens, thus decreasing their standard of living somewhat. Japan's citizens enjoy the highest average life span (81 years) in the world (compared to the United States— 77 years).[6]

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[3]OECD. p. 212.

[4]Economic Planning Agency (Japan). Essentials of Monthly Economic Report and Main Economic Indicators. February 2000.

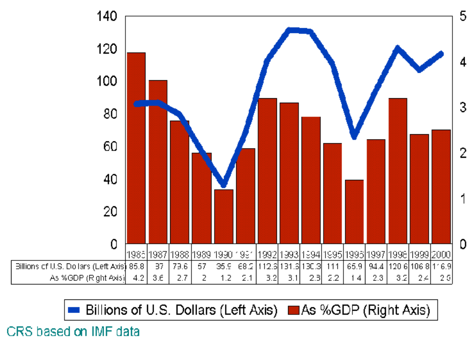
[5]Source: OECD. *OECD in Figures: Statistics on the Member Countries.* 2001 Edition. Paris. p. 12, 13.

[6]Source: World Bank. World Bank Atlas. 2001. Washington. p. 26, 27.

Foreign Trade Balances

Figure 4. Japan's Current Account Balances

1986-2000



Japan has continually run surpluses in its current account (balances on merchandise trade, investment income, and unilateral transfers) primarily due to large surpluses in its merchandise trade but increasingly as a result of rising income from investments abroad. (Figure 4) The current account surpluses are reflective of a high domestic household savings rate in Japan, around 15% of disposable income. At times the trade surpluses have presented a political problem for Japan as countries, such as the United States, that continually run bilateral trade deficits, have considered the deficits reflective of unfairness in Japan's trade policies and practices and have encouraged Japan to reduce its surpluses. On the other hand, Japan's large savings provide a pool of financial capital to the United States and other low- savings countries that need to borrow capital for investment. Japanese capital, for example, helps to finance the U.S. national debt.

Impact of Japan's Economic Problems

Japanese poor economic conditions have implications for Japan, the United States, and beyond. For Japan itself, continued slow growth or recession eventually could seriously damage the standard of living of the average Japanese citizen. Falls in national income would mean a decline in tax revenues that would worsen Japan's already difficult fiscal situation. Continued slow growth could affect business confidence and consumer confidence causing them to delay or reduce investment and spending, further exacerbating the gloomy economic trends. Furthermore, pronounced and extended poor economic performance can undermine popular confidence in political leaders and create political instability.

Factors Contributing to the Economic Problems

The causes of Japan's economic problems are varied and complex. They are rooted in some immediate factors: the burst of the assets bubble in the early 1990s and Japanese government macroeconomic policies that immediately precipitated the crisis. But they are also rooted in the fundamental structure of the Japanese economy — the complex web of government regulations and business conglomerates.

"Burst of the Bubble"

The trigger of the crisis was the burst in the assets "bubble" in the early 1990s. The assets "bubble" refers to the run-up of prices on land, stocks, and other assets in the mid-1980s to unsustainable levels. The bubble resulted from loose monetary policies intended to dampen the effects of an appreciating yen on exports in the mid-1980s and from liberalization of capital controls that unleashed funds seeking higher yields. In addition, banks were searching for new customers as firms, their biggest borrowers, turned from banks to equity markets for their financing. Banks turned to real estate and real estate-based loans as their targets. The sudden inflow of capital drove up asset prices.

The phenomenon fed on itself, perpetuating inflated asset values. Investors used the inflated assets to collateralize loans which they used to buy more assets. The inflated asset values created a "wealth effect" making consumers and businesses feel flush with cash, leading them to spend and invest accordingly. Business investment and consumer spending soared. Stock prices skyrocketed, as the Nikkei index jumped from 10,000 to 40,000 between 1984 and 1989. Real estate prices increased so rapidly as to make homes in Japan's biggest cities unaffordable without extra long-term mortgages. Japanese investments in U.S. real estate and businesses triggered fears of an "invasion" of U.S. industry. These trends contributed to high economic growth in Japan in the mid-1980s: Japan's real GDP grew an average of 3.9% per year; it peaked at 5.8% in 1988.

But beginning in 1989 and into the early 1990s, the Japanese monetary authorities determined that the low interest rates and the highly expansive money supply were not sustainable and threatened the economy with inflation. Japan's central bank, the Bank of Japan, raised its official discount rate from 2.5% in May 1989 to 6% by August 1990. The money supply growth was slowed dramatically and contracted in absolute terms in 1992.

Tightened credit and money supply brought a halt to asset buying, and the speculative bubble "burst" by the end of 1990. Stock prices plummeted. By the end of 1992, the Nikkei average had bottomed out at temporarily at 16,925, about 60% below its 1989 peak. It rebounded somewhat in the mid to late 1990s reaching levels close to 21,000. But in one of the signs of Japan's recent and continuing economic problems, the Nikkei average has plummeted below 10,000 in 2001.[7]

The economy was especially hard hit by the sharp drop in land and property prices which spawned a wave of defaulting loans, much like the U.S. savings and loan crisis of the 1980s. In Japan as a whole, urban land values declined an average 28% from the end of March 1991 to the end of March 1999. In the six largest Japanese cities where land values had jumped more than 200% from 1985 to 1991, they declined 62% from the end of March 1991 to the end of March Commercial real estate in these areas declined 78%.[8] The sharp downturn in asset values along with the tightened monetary policy precipitated a decline in economic growth in 1991 that began the continuing period of economic stagnation in Japan that has worsened to the present. Land prices have continued to decline.

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[7] Bank of Japan. Research and Statistics Department. *Economic Statistics Monthly.* Various issues.

[8] Management and Coordination Agency. Statistics Bureau. (Japan) Japan Statistical Yearbook 2000. Tokyo. p. 554.

The Financial Sector "Crisis"

The asset bubble exposed deep-seated structural problems in Japan's financial sector which contributed to Japan's anemic economic performance. The collapse of the real estate market and the stock market left many Japanese banks with a huge volume of loans which were not likely to be repaid. The financial crisis was due in part to the use of stocks and real estate as collateral; the number and size of the loans ballooned with the rise in asset values and actually fed the bubble and collapsed when the bubble burst.

The crisis has been caused also by government practices, particularly those of the Ministry of Finance, that oversees the banking sector. The practices included the so-called convoy policy, that of promoting growth throughout the banking sector with the stronger banks assisting the weaker ones, rather than allowing weaker ones to go bankrupt or merge with stronger ones. The collapse of the market also exposed questionable accounting practices that allowed banks to hide non-performing loans rather than having to write them-off.

As of March 2001, Japanese deposit-taking financial institutions held ¥43.4 trillion ($367.5 billion) in nonperforming loans, an increase from ¥42.4 trillion at the end of March 2000. Many analysts assumed that the Japanese government had under-reported the extent of the non-performing loan problem have placed the value at ¥ 140.9 trillion ($1.1 trillion), if one includes problems loans that could become nonperforming loans if Japan's economic slowdown continues or becomes a recession.[9]

The strain of the banking crisis and tighter capital/asset requirements from the Bank for International Settlements (BIS) challenged long-held government banking oversight policies and banking practices. The small institutions, including the *jusen*, or housing loan institutions, were the first hit with bankruptcy and closure. Between 1993-1996, all seven jusen closed as did several credit cooperatives, and a small regional bank. In 1997, a mid-sized life insurance company— Nissan Life Insurance and Sanyo Securities Co, both collapsed. More importantly in 1997 Yamaichi Securities and Hokkaido Takushoku Bank, Ltd. were allowed to fail, the first time in post-war Japanese history that major financial institutions were allowed to go under.[10] In 1998, the government nationalized the Long-Term Credit Bank (LTCB) and Nippon Credit Bank under a banking rescue program passed by the Diet in October 1998.

The burst of the bubble marked the beginning of Japan's economic crisis. The impact that the burst bubble has had on the financial sector has helped prolong and deepen the economic stagnation. A strong, stable financial sector is vital to the health of an economy. It is the sector that channels capital, the life-blood of a market economy, from those who have it (savers) to those who need it (investors). If that life-blood is slowed or cut off, the economy suffers.

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[9] U.S. Library of Congress. Congressional Research Service. *Japan's Banking Crisis.*by Dick K. Nanto. CRS Report RS20994.

[10]Lincoln, Ed. Japan's Economic Mess. JEI Report. May 8, 1998. no. 18A. p. 10.

Fiscal and Monetary Policies

Some analysts have also pointed to Japanese government fiscal and monetary policies as contributing to the economic malaise. Japan's fiscal situation deteriorated severely in the 1990s. From 1990 to 1995, the Japanese general government fiscal balance went from a surplus equivalent to 2.9% of GDP to a deficit equivalent to 3.7% of GDP. Gross debt increased from 65.1% GDP in 1990 to 80.6% GDP in 1995. Net debt (essentially gross debt minus social security contributions) increased to 11% GDP in 1995, and it is expected to grow as the aging Japanese population contributes less to government revenues and takes more in social security payments.[11] The deteriorating public finances resulted from the slowdown in economic activity in the early 1990s in Japan, due in part to the burst of the bubble, plus the additional costs of a series of stimulus packages.[12]

In anticipation of the fiscal problems Japan would face, the powerful Ministry of Finance strongly promoted more austere tax and expenditure policies. One of the major pillars of the austerity program was the passage of the Fiscal Structural Reform Act in 1997. Among other things, the act required that by Japanese fiscal year 2003, the government would no longer be able to issue bonds to finance budget deficits, and the general government deficit would have to decrease to 3% of GDP.[13]

The government began to take other measures to reduce its budget deficits. In April 1997, it increased the consumption tax from 3% to 5% and reversed a temporary tax reduction that had been imposed earlier to stimulate demand.[14] The government had timed the fiscal austerity measures in anticipation of a long-awaited recovery in Japan's economic growth. Indeed, in 1996, real Japanese GDP increased 3.9% after lackluster growth the previous years of the decade.[15] The general government deficit decreased to 3.4% in 1997 indicating a tighter fiscal policy. But the fiscal contraction, while financially prudent, contributed to the return of economic stagnation in 1997 and 1998. Japan's recent monetary and fiscal policies has been loose.

One school of thought on Japanese economic policy argues that Japan's macroeconomic policies have played the key role in Japan's economic stagnation. Economist Adam Posen, a member of this school, argues that the burst of the bubble was caused by the inappropriate contractionary fiscal and monetary policies in the early 1990s.[16] He further argues that when the government introduced fiscal stimulus

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[11]OECD. OECD Economic Surveys: Japan— 1996-1997. Paris. p. 54-55.

[12]Ibid. p. 59.

[13]Aghevli, Bijan B., Tamim Bayoumi, Guy Meredith. Structural Change in Japan: Macroeconomic Impact and Policy Challenges. International Monetary Fund. Washington. 1998. p. 174.

[14]OECD. OECD Economic Surveys: Japan— 1996-1997. Paris. p. 61.

[15]Ibid.

[16]Posen. Adam S. Restoring Japan's Economic Growth. Institute for International Economics. (continued...)

to boost demand, it was too little too late. The one exception was in 1995, when the government implemented a large fiscal stimulus package, and it resulted in the boom in economic activity in 1996. Posen has suggested that the Japanese economy still has room to grow through fiscal stimulus (potential growth) without triggering inflation nor would the extra fiscal debt overly burden the Japanese economy.

MIT economist Paul Krugman is another member of this school but focuses on the role of monetary policy. He has argued that the Japanese economy has entered into a "liquidity trap:" At very low interest rates individuals will willingly hold (not spend) all additions to the supply of money, thus rendering monetary policy ineffective.[17]

Structural Economic Problems

Another group of analysts argues that macroeconomic factors (fiscal and monetary policies) are not as important as structural rigidities within the Japanese economy, in addition to those in the financial sector that led to the financial assets bubble. Such rigidities, they argue, have not only led to Japan's economic problems but will prevent Japan from realizing its full growth potential unless they are removed.

One such economist, Richard Katz, argues that Japanese economic problems are rooted in what he calls its "dual economy."[18] The Japanese economy is really a two-segmented economy, he argues. One segment is highly efficient and consists of sectors that have proved competitive in the world economy and are highly productive. Industries in this segment include cars, electronic products, computers, semiconductors, and capital machinery. The second segment are those sectors that are very inefficient with low productivity. They survive through protective government regulations and private business practices. This segment includes industries that produce glass, cement, paper, petroleum products and petrochemicals, processed foods, and basic steel. It also includes many elements of the service sector, such as financial and retail services.

According to Katz, and others, the Japanese economy had been able not only to survive but thrive until recently because the competitive part of the dual economy was so efficient that it was able to prop up the noncompetitive part. They did so by having to depend on those sectors for their inputs. For example, the car manufacturers would buy flat glass, basic steel, and other components from domestic manufacturers but at higher prices than they might have had to pay if they bought from more efficient foreign suppliers. They sold their products through designated retailers. They also had to pay high prices for energy.

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[16](...continued)
Washington. August 1998. 186 p. Ibid.

[17]Krugman. Paul. Japan's Trap. MIT. May 1998.
[http://web.mit.edu/krugman/www/japtrap.html]

[18]Katz, Richard. Japan— the System that Soured: The Rise and Fall of the Japanese Miracle. M.E. Sharpe. Armonk, NY. 1998. 463 p.

This arrangement could continue as long as the export sectors remained sufficiently competitive to absorb the costs of the less efficient sectors. But Katz argues that in the mid-1980s, with the sharp appreciation of the yen, Japanese exporting firms could no longer absorb the costs without sacrificing their ability to compete globally. Many of the industries, particularly the car manufacturers and electronics manufacturers, were forced to relocate operations abroad.

With demand for Japanese exports cut and producers moving abroad, Japan made up for the loss of demand by pouring more of its financial resources into investment driven by a loose monetary policy. This strategy allowed Japan to boost growth rates in the 1980s. Yet, Katz points out, those investments were inefficient, yielding lower returns than investments made in other industrialized countries. The continual pouring of funds into assets created the bubble and sowed the seeds of the economy's destruction. When the bubble burst in the early 1990s, it signified the end of the "last hurrah of a faltering system trying to pump itself up."

Along with Japan's "dual economy," Katz points to a second, related problem — a chronic inability to consume all that it produces. The Japanese economy saves too much largely because of the lack of an adequate social safety net and social security (retirement) program. If that savings cannot be exported it is "consumed" through investments which have become increasingly inefficient, or pumping up of the economy through government public works programs.[19]

The East Asian Financial Crisis

The currency crisis that hit several large East Asian economies —Thailand, Indonesia, Malaysia, and South Korea — from mid-1997 contributed to prolonging Japan's economic problems.[20] Japan had become more reliant on East Asia as an export market and the growth in Japanese off-shore production in East Asia created customers for exports of Japanese technology. In 1996, Asia accounted for 44% of Japanese exports. In 1997, after the onset of the Asian crisis, the share declined to 42% and by the end of 1998, to 35% (although it increased somewhat to 37% by the end of 1999). In 1998, Japanese exports to those countries most sharply hit by the financial crisis declined dramatically: South Korea— 36.4%; Thailand— 30.7%; Malaysia— 30.7%; and Indonesia— 54.5%. Furthermore, in 1998, imports from the countries hardest hit by the financial crisis declined very sharply: South Korea— 69.3%; Thailand— 74.6%; and Malaysia— 78.2% The decline in Japanese imports made it more difficult for these countries to export their way out of the crisis. (Japanese imports from Indonesia actually increased 58.8%.)[21]

In addition, Japanese banks had been heavily exposed in those countries. At the end of 1996, before the Asian crisis hit, 62.3% of international lending by Japanese

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[19]Ibid. p. 8.

[20]For information on the Asian financial crisis see CRS Report RL30012. Global Turmoil: Contagion, Effects, and Policy Responses, by (name redacted).

[21]Ministry of Finance (Japan). Obtained from website: [http://www.mof.go.jp/english/trade-st/199828ce.htm].

banks was to eight East Asian economies: Indonesia, South Korea, Thailand, Malaysia, the Philippines, Taiwan, Hong Kong and Singapore.[22] Japanese banks faced the possibility of their loans there going bad which added to the banking sector's already enormous problems.

Japan's Response to the Economic Problems

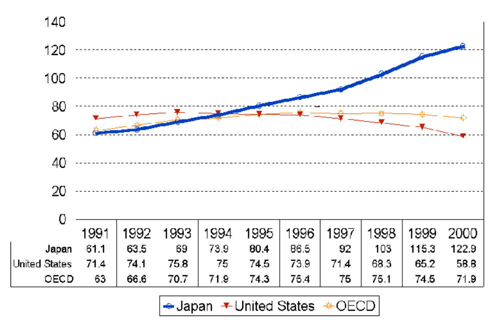
The examination above of Japan's economic problems demonstrates that a number of factors have contributed to them: the burst of the asset bubble; the crisis in the financial sector; macroeconomic policies; structural problems in the economy; and the East Asian currency crisis. Successive Japanese governments since the 1990s have responded with piecemeal initiatives on these various fronts with little in the way of near-term success, judging by Japan's continuing poor economic outlook.

Macroeconomic Measures

Macroeconomic policies are defined as a government's policies on spending and taxation (fiscal policy) and on currency and credit emissions and interest rates (monetary policy). These economic policy tools can be very powerful, but their use is constrained by the financial resources available to a government and also by the need to maintain price stability.

Fiscal Measures. Since 1992, the successive Japanese governments have passed and implemented 10 "economic stimulus packages," combinations of tax cuts and spending increases, to try to boost the limping economy. But they have had to do so against the backdrop of an aging population that will, in time, demand more in terms of pensions and contribute less in taxes putting additional demands on the government budget.

Figure 5. Gross General Government Debt, 1991-2000
(As Percentage of Nominal GDP)



	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Japan	61.1	63.5	69	73.9	80.4	86.5	92	103	115.3	122.9
United States	71.4	74.1	75.8	75	74.5	73.9	71.4	68.3	65.2	58.8
OECD	63	66.6	70.7	71.9	74.3	75.4	75	75.1	74.5	71.9

Source: OECD

The extra spending is a political gamble for Japanese political leaders. If the stimulus packages prove effective, the Japanese economy could return to sustained economic growth. However, if the economy does not grow, or does not grow sufficiently to boost business and consumer confidence, then Japan is faced with a very high debt burden which would become harder to pay off if the economy is not generating increasing income. Japan already has the highest gross debt /GDP ratio among industrialized countries. Figure 5 indicates that between 1991 and 2000 Japan's ratio had doubled to over

[22]U.S. Library of Congress. Congressional Research Service. The Asian Financial Crisis, the IMF, and Japan: Economic Issues. CRS Report 98-434, by (name redacted). p. 26-27.

120%. The ratio for the United States had declined to around 60% while the average ratio for all OECD countries had increased slightly from 63% to 72%.

Mindful of the growing financial burdens, current Japanese prime minister Koizumi vowed that his government would cap government spending by limiting government deficit financing to ¥30 trillion (about $249 billion) in Japanese fiscal year 2002 (April 1, 2002-March 31, 2003).[23] But implementing such a policy is challenging when an economy is undergoing slow growth or recession, as is the case with Japan. Furthermore, much of the funds in previous stimulus packages have gone to public works projects that have been have been the bread and butter of Liberal Democratic Party (LDP) constituents. Indeed, the prime minister faces pressure from within his own party, the LDP, to reconsider the policy.[24]

Monetary Policy. The Japanese authorities have maintained an expansionary monetary policy since September 8, 1995, a policy commensurate with a slow growing or recessionary economy. The Bank of Japan (BOJ) has reduced its official discount rate (the rate at which it lends funds to other banks) in stages from 6.0% in August 1990. By February 1999, the BOJ had dropped the rate to zero, a rate which it maintained until August 2000 when, with Japan's economic prospects looking somewhat brighter, it raised the rate to 0.25%.[25] However, the Bank in effect returned to zero rate policy in February 2001 as the Japanese economy faced deflationary pressures. The Bank indicated that the rate would be in place until consumer price changes turn positive.[26] Commensurate with the more expansionary monetary policy, the BOJ announced in August 2001, that it would increase the "current accounts" of Japanese private banks, that is, the cash balances held in their accounts with the BOJ, from a total of ¥5 trillion to ¥6 trillion. In late September 2001, BOJ chairman, Masaru Hayakami, announced that the target would be set "above ¥6 trillion," indicating that the Bank would do what it takes to encourage spending.[27]

It is important to note that Japanese monetary policy has not been as loose as it might first appear. Inflation rates in Japan have been very low, far below those of most industrialized countries. Therefore, real (adjust for inflation) interest rates in Japan, which are the effective rates, are higher than in many countries. In addition, even though nominal interest rates have been low, the growing problems in the banking sector have stifled credit expansion.[28]

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[23] Ibison, David. Koizumi Determined to Limit Japanese Bond Issues. *Financial Times.* August 28, 2001.

[24] *Japan Digest.* September 11, 2001. p. 3.

[25] OECD. *Economic Surveys– Japan..* Paris. December 2000. p. 71.

[26] International Monetary Fund. *IMF Concludes 2001 Article IV Consultation with Japan*. Public Information Notice (PIN) No. 01/85. August 10, 2001.

[27] *Japan Digest.* September 24, 2001. p. 3.

[28] IMF, World Economic Outlook, October 1998. p. 113.

Banking Reform and Other Structural Changes

Many Japanese policymakers and other observers long recognized that Japan's financial sector was highly inefficient and subject to corruption. Heavy government regulations prevented the sector (including banks, trust banks, securities companies, insurance, and other credit institutions) from adequately responding to the competitive demands of a global economy. These problems became especially apparent when the financial bubble burst and banks were left holding bad loans. The proliferation of troubled banks challenged the long-held government policy of trying to keep all institutions afloat, the "convoy system." Government regulations made it difficult for banks and other lenders to offer new financial services that were tailored to new markets. Troubled domestic financial institutions could not merge with foreign institutions to shore up their capital base and the financial sector was isolated from foreign competition.

In November 1996 the then Hashimoto government announced a sweeping program of financial reforms, popularly called the "big bang." Among other things, the program is designed to break down barriers among the various types of financial institutions to increase competition among them. The main provisions of the big bang included:[29]

- imposing higher penalties on financial institutions for illegal acts;
- loosening government restrictions on management of investment trusts, pension funds, and other assets; allowing individuals and companies to make foreign currency transactions without prior government approval;
- making the Bank of Japan independent of the Ministry of Finance;
- opening the Japan Financial Inspection Agency;
- eliminating licensing requirements for securities brokerages;
- eliminating restrictions on commissions on securities trades; and
- removing barriers to banks, insurance companies; trust banks, and securities companies from operating in one another's sectors.

In addition to the "big bang," Japan signed the World Trade Organization's (WTO) financial services agreement in December 1997 which requires signatory governments to allow foreign firms to participate in domestic financial markets. Furthermore, in April 1998, the Bank of Japan began to enforce tighter capital/asset ratios as required by the Bank of International Settlements (BIS). Enforcing these standards may have curtailed the ability of Japanese banks to lend. Japan and the United States also engaged in bilateral negotiations and agreements aimed toward opening Japan's markets for insurance and other financial services to foreign competition.

The "big bang" is designed to be implemented over time and will affect the economy gradually. But Japan faces the immediate crisis of a banking sector in deep trouble, which has led to the loss of depositors' confidence and to a "credit crunch" (insufficient credit available to viable lenders). In October 1998, the Japanese

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[29]Taken from CRS Report 98-475, *Japan's "Big Bang"and Other Financial Deregulation*, by (name redacted).

parliament approved a program initiated by the government of then Prime Minister Obuchi. The program included over $500 billion in funding, to deal with nonperforming loans and weak banks. It also included the establishment of new government agencies to manage and otherwise dispense with nonperforming loans and failed banks.[30]

Financial reform is very important but only a part of the economic restructuring efforts that the Japanese government has taken in the 1990s. Japan has grappled with economic restructuring for many years. In 1986, a report released by an advisory commission led by former Bank of Japan chairman Haruo Maekawa asserted that Japan needed to take measures to stimulate domestic demand by relying less on exports to stimulate economic growth in the face of growing trade surpluses and political pressure from trading partners, including the United States. These measures were to include economic deregulation. But the Japanese government did little in response.

The Japanese government has taken economic reform more seriously as it has faced continued economic stagnation in the 1990s. Also the government's poor response to the Kobe earthquake in 1995 manifested the corruption in some government ministries, the lack of effective inter-ministerial coordination, and arcane and inefficient government regulations.

The Japanese government embarked on deregulation and restructuring on a number of fronts. In March 1995, the government initiated a Deregulation Action Program (DAP), a three-year program (FY1995-FY1997) designed to make regulations the exception rather than the rule in the Japanese economy. The initial program targeted about 1,100 measures to be taken but was revised and increased to 2,800 by March 1997. Among other things, the program focused on strengthening the enforcement of the Anti-Monopoly Act, Japan's main authority for anti-trust activity, in order to improve efficiency and increase competitiveness in Japanese industries. In addition, the DAP would reduce barriers to entry of new firms to industries, review regulations that inflate prices of electricity and other utilities, cut consumer protection regulations and environmental regulations to "minimum required," and reduce regulations that bar entry of foreign entities into the Japanese economy. The program focused on regulations in the following areas: housing and land; information and telecommunications; distribution; standards, certification and import procedures; financial services including securities and insurance; energy; labor; and others.

In 1996, the Hashimoto government raised the priority of economic restructuring. It did so by introducing a multifaceted economic reform program that included reform in administration (the government ministries and other agencies responsible for economic matters); fiscal structure (discussed above); financial system (discussed above); and education.

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[30]Choy, John. Bank-Rescue Legislation, Recapitalization Plan Move Quickly through Diet. JEI Report. October 16, 1998. 39B p. 1-3.

To date Japan has made small but noticeable progress in deregulation. More large retail stores have established a presence in Tokyo and other cities giving Japanese consumers wider choices at reduced prices. The telecommunications sector is under reorganization with the privatization and eventual breakup of Nippon Telegraph and Telephone (NTT); removal of barriers between the domestic and long-distance markets; and easing of barriers to permit more rapid introduction of new services such as cell phones. In the energy sector, price controls on gasoline and restrictions on establishing self-service stations have been lifted and the deregulation of the electricity sector is being considered.[31]

Transportation costs for freight and passengers are much higher in Japan than in other industrialized countries. Japan has heavily regulated the entry of new firms ostensibly to prevent supply capacity from getting too large. To reduce costs and improve efficiency the government has liberalized restrictions on the number of airlines and flights to introduce more competition in the industry and barriers in shipping and passage transport (trains, buses, and taxis) are being loosened. The government is taking steps to improve efficiency of land use by revising regulations on land use and housing.[32]

Legislation was passed to reorganize the government in order to reduce the number of ministries and streamline their operations, cutting costs and bureaucratic red tape. Importantly, the government has increased resources at the Fair Trade Commission to improve enforcement of anti-competition laws and has increased penalties for violations.[33]

Although the Hashimoto and Obuchi governments took major steps to reform the Japanese economy (and these steps have had results), critics point out that Japan's path to economic restructuring and reform remains a long one. The OECD has argued that Japan needs to accelerate the pace of reform implementation or else see popular confidence in the program erode. It also needs, according to the OECD, to expand efforts in banking, telecommunications, energy, land-use reform, taxation policy, and other areas for economic restructuring to be effective.[34] Economist Richard Katz has argued that Japanese efforts to date have only skimmed the surface of what needs to be done, and that Japan needs to undertake more fundamental changes that eliminates the "dual economy," primarily by more radically reducing the government's role in economic decisionmaking.[35] Economist Edward Lincoln remains skeptical that Japan can address the financial practices that got the economy in trouble in the first place.[36]

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[31]OECD. OECD Economic Surveys: Japan 1998. Paris. 1998. p. 124-128.

[32]Ibid. p. 129-130.

[33]Ibid. p. 138-140.

[34]Ibid. p. 12-14.

[35]Katz, p. 13-21.

[36]Lincoln. Edward J. Japan's Financial Mess. Foreign Affairs. Vol. 77. no. 3. p. 63-64.

The Economic Program of Prime Minister Koizumi

In April 2001, Junichiro Koizumi was elected to the presidency of the LDP and, therefore, assumed the office of prime minister. He succeeded Yoshiro Mori, who, himself, had assumed the leadership in April 2000 after Obuchi suffered a fatal stroke. Koizumi was elected by the grass roots membership of the LDP, much to the chagrin of the party's senior leaders. Koizumi campaigned for the job on a platform of economic reform and seemed to gain popularity among those who wanted change in Japan.

Shortly after assuming the leadership, Koizumi announced a package of economic emergency measures, or guidelines, to revive the economy. His government expanded on those guidelines in June 2001 by releasing a economic policy framework which sets out the main macroeconomic and structural objectives and strategies for his government.

Banking reform has become a centerpiece of the Koizumi government's economic strategy. The government's program calls for a "Drastic Disposal of Non-Performing Loans (NPLs)," that is, to encourage banks to write-off completely their nonperforming loans in 2-3 years.[37] But that objective has proved an arduous one. One issue has been to determine the scope of the problem. The volume of what non-banking analysts consider to be nonperforming loans has greatly exceeded the number of nonperforming loans officially reported by banks. A second issue is the potential economic impact. Banks are reluctant to write-off loans of major clients with whom they have a long-term relationship and government officials are concerned about the impact on the economy if major companies are forced to close down because they can no longer get bank financing. On August 30, 2001, the head of the Financial Supervisory Agency, the agency that overseas bank reform measures , announced that the bad loan problem could not be resolved in 2-3 years and that by 2007, six years from now, perhaps half of the bad loans could be resolved.[38]

Besides banking reform, the Koizumi government's program sets out other economic reform objectives in order to revitalize the Japanese economy:

- encouragement of research and development;
- reform of government regulations and the judicial system to develop an environment for greater competition especially in the telecommunications and energy industries;
- reform of the structure of the capital and real estate markets and restructure the labor market;
- reform of the tax system;

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[37] EIU. *Country Reports: Japan.* June 2001.

[38] DRI-WEFA. *Japan Report.* September 27, 2001. [http://cas.dri-wefa.com].

- improvement of the social infrastructure by making the public works system more efficient; and
- reform of the social safety net – social security, medical system, pension system, nursing and childcare – so that it meets the needs of the changing Japanese population.[39]

The program is ambitious and addresses many problems that Japanese and foreign experts have cited as the roadblocks to full economic recovery in Japan. But skeptics may point to more than 25 years of Japanese political economic history and that included economic efforts that failed produced only lackluster results.

Impact of Crisis on the U.S. Economy and the U.S. Response

As the second largest economy in the world, Japan makes an impact. And when changes, positive or negative, occur in the Japanese economy, they can have significant effects on the rest of the world, especially smaller countries that are highly dependent on trade and foreign capital. The United States is the largest economy in the world — twice the size of Japan — and, therefore, not as vulnerable to external economic changes as are smaller countries. Nevertheless, Japan's economic stagnation has affected the U.S. economy, especially in foreign trade balances and investment flows.

One result of Japan's economic stagnation has been the rise in financial capital outflows from Japan. For many years, Japan has been a net "exporter" of financial capital, a product of a high savings rate that exceeds its rate of domestic investment. But during the recent periods of recession in Japan, the capital outflows surged as the savings rate has remained high while the rate of growth in domestic investment has at times been negative. The United States has, for many years, been a net "importer" of financial capital, a product of a very low savings rate that is exceeded by its rate of investment. The United States has been a major recipient of capital from Japan. It has, therefore, experienced increasing surpluses in its bilateral capital account with Japan.[40] The inflows of capital from Japan help to augment the pool of capital available to investors in the United States, putting downward pressure on U.S. interest rates.

The mirror image of the capital account in the U.S. balance of payments is the current account. If the United States incurs surpluses on capital account, it must then

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[39] Jetro. *Koizumi Government Adopts "Solid Policy Framework" to Promote Economic Rebirth in Japan.* June 26, 2001. [http://www.jetro.org/newyork/].

[40] U.S. Department of Commerce. Bureau of Economic Affairs. Survey of Current Business. July 2001. p. 77

incur deficits on current account. The U.S. current account deficit with Japan soared to$97.5 billion in 2000.[41]

The closely watched merchandise trade balance is a major portion of the U.S. current account imbalance with Japan. U.S. merchandise trade balances with Japan deteriorated after Japan's asset bubble burst. The U.S. merchandise trade deficit with Japan soared over 50% between 1991 and 1994, from $43.4 billion to a record $65.7 billion. From 1994 to 1996 the trade deficit with Japan declined as U.S. exports jumped 26%. But from 1996 through 1999, U.S. exports to Japan declined while U.S. imports increased causing the deficit to worsen to $74 billion. In 2000, U.S. exports to Japan picked up, but imports increased more rapidly causing the deficit to hit a record $81.3 billion. The slowdown in both the Japanese and U.S. economies have led to a decline in overall bilateral trade in 2001.

Table 1. U.S. Merchandise Trade with Japan, 1991-2001

($ billions)

Year	Exports	Imports	Balances
1991	48.1	91.5	-43.4
1992	47.8	97.4	-49.6
1993	47.9	107.2	-59.4
1994	53.5	119.2	-65.7
1995	64.3	123.6	-59.3
1996	67.5	115.2	-47.6
1997	65.5	121.7	-56.1
1998	57.9	122.0	-64.1
1999	57.5	131.4	-73.9
2000	65.3	146.6	-81.3
2000*	31.5	71.3	-39.8
2001*	31.4	65.9	-34.5

* First six months

Source: U.S. Department of Commerce. Bureau of the Census. Exports are total exports valued on a f.a.s. basis. Imports are general imports valued on a customs basis.

Since 1997, Japan dropped from being the second most important U.S. export market, after Canada, to the third most important (with Mexico moving up). It has remained the second most important source of imports to the United States. U.S. exporters of computers and computer components, agricultural products (such as corn and soybeans), and lumber and wood products saw their markets in Japan shrink substantially. U.S.-based car manufacturers, who were just beginning to make inroads

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[41]Ibid.

in the Japanese market saw their exports to Japan shrink as well, albeit from a small base. Some exporters, such as producers of aircraft and parts, and integrated circuits, actually increased their business in Japan. U.S. import levels from Japan have increased in the last few years.

Nevertheless, as the second largest economy, a strong Japan makes a significant contribution to world economic growth, and its stability is critical to ensuring the stability of world financial markets and the world economy as a whole. As the world's largest creditor, Japan is the source of large volumes of financial capital to the United States and other countries, sudden withdrawals of which could have strong, adverse effects on U.S. and world financial markets. Japan is also a dominant force in the International Monetary Fund, the World Trade Organization, and other multilateral and regional economic organizations.

The United States also has a strong interest in the economic and financial stability in East Asia. The negative effects of Japan's economic problems on those countries thus indirectly affects the United States. Some observers have argued that Japan's failure to increase imports from East Asia have forced those countries to sell more in the U.S. market thus increasing their trade surpluses with the United States. There is not much foundation to this argument since the growth in U.S. trade deficits with those countries was primarily the result of decreased U.S. exports rather than increased U.S. imports.

Japan's poor economic performance has tended to dominate U.S.-Japan relations since the 1990s. U.S. policymakers, the business community, and the agricultural sector have been eyeing economic developments in Japan as U.S. export markets have been shrinking with the rest of the Japanese economy. They are also concerned that Japan would strive to "export" its way to recovery by maintaining a weak exchange rate to boost the price competitiveness of Japanese exports in the U.S. market. In that regard, U.S. policymakers in the executive branch, including the President, and in the Congress, have been pressing Japan to proceed with reforming its banking sector and restructuring the rest of its economy.

For many years, the United States has made restructuring and economic deregulation direct or implicit elements of trade negotiations with Japan. U.S. negotiators and industry representatives have long argued that government policies and regulations, by effect if not by design, protect inefficient domestic producers from foreign competition and provide Japanese exporters with an unfair advantage over competitors in the United States and other countries. Furthermore, the structure of Japanese business, especially the dominance of cross-ownership conglomerates *(keiretsu)*, their business practices, and their tolerance by the Japanese government have prevented U.S. firms from competing in Japanese markets to a degree, these firms believe, that is commensurate with their competitiveness in other markets. Deregulation, competition policy, and economic restructuring underlie many of the current bilateral sector specific trade disputes with the United States: flat glass, autos and auto parts, photographic film, and insurance.

The Reagan Administration engaged Japan in the Market-Oriented Sector-Selected (MOSS) negotiations that targeted Japanese government regulations and other impediments to imports from the United States in selected sectors. The first

Bush Administration negotiated with Japan under the Structural Impediments Initiative (SII), which targeted government policies and regulations and private business practices across sectors. The Clinton Administration combined the two types of negotiations under the U.S.-Japan Framework for a New Economic Partnership with a strong emphasis on sector negotiations and obtaining quantitative results.

On June 30, 2001, President George W. Bush and Prime Minister Koizumi announced the formation of a new framework for addressing economic issues of mutual concern. The "U.S.-Japan Economic Partnership for Growth," (Economic Partnership) follows and draws from bilateral forums that previous U.S. administrations established with their counterpart governments in Japan. The Economic Partnership will consist of several initiatives or dialogues to include participation from subcabinet level leaders from both governments and participation from members of the business communities and other non-government sectors from both countries. The U.S.-Japan Subcabinet Economic Dialogue will provide overall direction for the Economic Partnership. Other elements of the Economic Partnership include: the Regulatory Reform and Competition Policy Initiative (with working groups on telecommunications, information technologies, energy, and medical devices and pharmaceuticals, plus a cross-sectoral working group); the Financial Dialogue; the Investment Initiative; and the Trade Forum. Each one of these elements will be responsible for reporting to the president and the prime minister on the progress of their work.[42]

The Outlook for the Japanese Economy

Few would deny that Japan has been and remains in a very serious economic situation. The unprecedented (for post-war Japan) poor economic growth rates, rising record unemployment rates, and the lack of business and consumer confidence paint a rather dismal picture for an economy that was the “economic miracle”for many decades. The build-up of the assets bubble in the 1980s (and its bursting at the beginning of the 1990s) triggered Japan’s economic problems. The sudden and continuing drop in the values of real estate, stocks, and other assets sharply cut into the wealth of Japanese and sent the banking sector, suddenly holding billions of dollars in bad loans, reeling. The crisis has adversely affected the sense of well-being of the average Japanese citizen.

The near-term outlook for the Japanese economy is not promising. Many of the major economic forecasters are predicting very slow or negative economic growth in 2001 and probably 2002. If many observers agree that Japan’s economic situation remains serious they disagree on the fundamental causes, and therefore on the solution. The debate pits those who argue that fiscal stimulus and/or monetary stimulus will unleash economic growth against those who argue that such macroeconomic measures will provide a short-term spurt at best unless Japan undertakes fundamental structural changes.

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[42] For more information on U.S. trade policy toward Japan see CRS Issue Brief IB97015, *U.S.-Japan Economic Ties: Status and Outlook.*

Determining which school of thought is correct is a task beyond the scope of this report. Nevertheless, based on Japan's experience since the 1990s, one can conclude that Japan's road to recovery depends on a proper balance between macroeconomic policies and economic restructuring. The rise in the asset bubble and its burst resulted from structural problems within the banking sector. Confidence within that sector will have to be rebuilt if it is to exercise its important role as a financial intermediary in the Japanese economy. Japan can also realize important productivity gains which would contribute to economic growth if it pursues deregulation and restructuring in other important sectors. At the same time, as Japan's experience in 1996-97 proved (when economic recovery was truncated by a premature tightening of monetary policy and increase in taxes), if the government does not conduct the correct fiscal and monetary policies, economic growth can be prematurely aborted.

In pursuing macroeconomic stimulus, the Japanese government is constrained by the limitations of its revenues and of its ability and willingness to borrow to finance deficits. It is constrained in pursuing deregulation and restructuring by the ability and willingness of policymakers to confront the various interest groups within the bureaucracy and elsewhere that have had stake in the status quo. Japanese governments under various leaders have attempted to tackle these challenges with limited success. Often failure to achieve complete success has lead to the political downfall of those leaders.

Prime Minister Koizumi and his government face the many of the same challenges. Their program addresses many fo the obstacles to economic growth that Japanese and foreign experts have cited but already the government is meeting resistence and doubt.

Implications and Policy Options for the United States

U.S. economic policy toward Japan has reflected a broad range of U.S. national interests and pressures, and U.S. policy will have to continue to reflect those interests if it is to be effective. These interests include those in the American business community and agriculture that are looking for unfettered access to markets and strong Japanese demand for their exports and investments as well as those who are wary of competition from Japanese production. Beyond the specific interests of individual sectors are the overall interests of the United States in a robust and stable Japanese economy.

Japan is the largest economy in East Asia where it accounts for roughly 2/3 of the region's GDP. Japan serves as a model for economies in transition, such as China and Vietnam, and is critical as an engine of economic growth in the region.

In the foreign policy and national security area, Japan is an important world partner and chief ally in Asia. The United States and Japan face the mutual threat of an unstable North Korea and also the challenge of how to manage relations with a rapidly emerging China. A strong and robust Japan is vital to fulfilling its role as a partner of the United States in meeting these foreign policy challenges.

But as important as Japan's economy is to the United States, the direct policy influence the United States can have on the Japanese economy is limited at best. The United States could promote economic growth in Japan by selling yen for dollars or by boosting U.S. interest rates to drive down the value of the yen. A more expensive dollar/cheaper yen would make Japanese exports cheaper and would increase Japanese exports to the United States, all other factors remaining the same. But such a policy option would present other problems for the United States: Increased imports from Japan would increase the U.S. trade deficit, which could prove politically sensitive especially with those sectors of the U.S. economy feeling the increased competition from Japanese imports. Furthermore, higher interest rates would slow down U.S. economic growth.

National sovereignty restricts the influence the United States can exert in shaping Japanese economic policy, although outside pressure has often raised the consciousness in Japan with respect to a problem and can speed up decisionmaking. Decisions on macroeconomic policy and economic reform are within the purview of the Japanese government, and policymakers will undertake them within the context of what they perceive to be Japan's national interests.

But those limitations have not prevented the United States from defending its interests and pressuring Japan to move forward with deregulation and economic stimulation. The United States will likely continue to do so in bilateral negotiations on sector specific issues and on the broader issues of foreign investment and deregulation. The United States also will likely continue to work with Japan on such issues in multilateral fora, such as the World Trade Organization (WTO), and the Organization for Economic Cooperation and Development (OECD). An effective U.S. approach in these negotiations would underscore the mutual benefits to both countries of Japan following U.S. suggestions.

In the long term, if successful, Japan's efforts to overcome its economic difficulties might present the United States with significant opportunities. Many of the structural problems have acted as barriers to U.S. exports and investments in Japan and the source of much friction between the two countries. If Japan can successfully address these structural problems, it would likely improve market access in Japan and help alleviate the bilateral trade and investment friction. In the nearer term, the best U.S. defense against continued economic stagnation in Japan will be maintaining U.S. economic strength.