Japan is now in the midst of a fierce recession and, by no coincidence, the most far-reaching transformation of its economic system since the Meiji Restoration in 1867. In part, the severity of the recession has resulted from the unwinding of the asset deflation – the puncturing of the real estate and stock market bubbles – of the 1980's. But the pain has been magnified by the slow pace at which Japan has been restructuring both its financial system and corporate sector. Happily, there is now a clear path to recovery.

BY DAVID HALE

Since the Second World War, Japan's economic system has best been described as "stakeholder capitalism." The corporate sector used markets to allocate resources, both human and material. It did so, though, within a framework of managed competition that tolerated cartels and minimized the role of profits in corporate decision-making.

Japanese corporations were seen as communities in which size, employment and customer relationships were all part of the bottom line. There was little pressure from shareholders to promote profitability because most corporations were controlled by cross-shareholding networks that included a main bank plus suppliers and industrial customers. In the 1980's, just one-quarter of Japanese corporate equity belonged to independent "retail" shareholders.

One consequence was a level of investment 50 to 100 percent higher than other industrial countries, financed primarily by bank lending. This investment-led system helped to produce stunning economic growth during Japan's catch-up period with the West in the first three postwar decades. But as the economy matured, it generated great inefficiencies that set the stage for stagnation in the 1990's.

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DESPERATE TIMES

The Japanese economy is now suffering from four related crises that are converging to force significant restructuring.

First, the banking system has close to $1 trillion worth of problem loans, the result of the collapse in asset values since the late 1980's and the recession that has more recently taken hold of the economy. The property market has lost a stunning 80 to 90 percent of its value since the peak in 1989, while the stock market has fallen by about 75 percent.

Non-performing loans, coupled with the decline in the stock market, have reduced bank capital to levels that effectively inhibit credit expansion. Where shell-shocked banks do have ample capital, they simply are not willing to take on additional risk.

Tokyo initially denied the banking problem was serious. But by late 1998 it bowed to reality, permitting a significant injection of public money to keep the banks afloat. It also established the Financial Service Agency to regulate the banks and promote restructuring by nationalizing weak institutions or encouraging them to merge.

The agency hopes to create a consolidated system with four megabanks and four super-regional banks, compared with the old system of 13 commercial banks, seven trust banks and 75 regional banks. It also intends to reduce the role of banks as shareholders in corporations.

In the old, incestuous cross-shareholding system, banks owned about 25 percent of all corporate equity, while their borrowers and friendly industrial groups controlled the great bulk of the banks' own shares. The cross-shareholding networks were thus the counterpart to a financial system in which banks provided practically all of Japan's corporate lending.

The second crisis was brought on by the collapse in corporate profitability during the 1990's. Last year the average return on equity in Japanese corporations was just 2 to 3 percent, compared with 22 percent in the United States and 15 percent in Western Europe.

Japan's high level of investment had long kept profitability below United States levels, but even in the late 1980's it was still in the 8 to 9 percent range. The economic downturn of the 1990's depressed domestic spending and created capacity gluts in key sectors, including autos, steel and consumer electronics. Compounding the problem, Japanese corporations were slow to restructure because of the country's almost ideological belief in high investment and full employment.

During the late 1980's and early 1990's, Japan typically devoted 18 to 20 percent of its gross domestic product to new plant and equipment – compared to about 10 percent in other mature industrial economies. Investment's share of G.D.P. has recently fallen to just 14 percent, but it is still too high for a country in recession.

By the same token, there is great cultural and social resistance to trimming employment. Many companies have announced voluntary retirement programs, but are reluctant to lay off workers. Since the Japanese corporate sector pays more of its compensation as annual bonuses based on revenues or output, there has been more flexibility in pay than would be possible in the United States. But still bigger cuts in compensation will be needed if the country is to avoid a large increase in unemployment.

So many companies are in trouble that unemployment has topped 4.4 percent, up from a previous postwar peak of about 2 percent. But the best guess is that Japanese corporations remain overstaffed by about 10 percent. Thus an aggressive corporate restructuring could easily double joblessness.

In the United States, a profitability crisis comparable to Japan's would set the stage for a wave of corporate mergers and asset divestitures. Japanese resistance to restructuring kept the total value of mergers and acquisitions during 1998 to just 2 percent of the rate in the United States. Still, the volume of mergers as well as foreign takeover bids has increased markedly from the past. As the corporate sector moves further to dismantle cross-shareholding, both mergers and foreign takeovers are likely to rise.

The collapse of profitability led to the third crisis, the effective insolvency of pension funds. With the pension funds' return on assets in the tank, Goldman Sachs estimates that the system's unfunded liabilities could be as large as 80 trillion yen – the equivalent of roughly $700 billion.

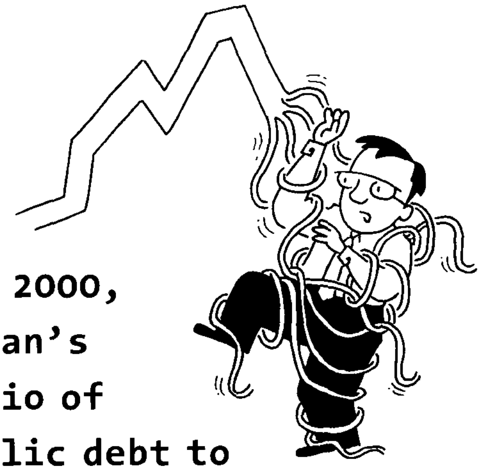
In 1998, Japanese insurance companies offered a return of only 2.5 percent on the retirement savings under their control, and this spring they plan to lower the rate to 1.5 percent. This crash in asset returns has forced many corporations to curtail retirement benefits to their *current* retirees. And the depth of the problem will soon be more visible: In two years, corporations must begin reporting unfunded pension liabilities.

TOM BLOOM (3)

Since corporations will have to inject tens of trillions of yen into the pension funds to make them solvent, a great debate has begun about how to finance the injection. The emerging consensus: transfer corporate cross-shareholdings into the pension funds. Cross-shareholdings now total about 133 trillion yen, or more than $1 trillion. So the move would do double duty, helping to untangle the cross-shareholding mess while reducing the unfunded pension liabilities.

Still to be decided is what the pension fund trustees would then do with their newly acquired equity. The funds' positions would be so heavily weighted in the bank stocks – corporations now own a lot of bank stock – that most would probably feel compelled to sell a portion. Note, too, that Japanese corporations are also turning to foreign managers to improve their asset returns, and these new managers will be even less protective of the old cross-shareholding arrangements than were the domestic ones.

The rise of pension funds in the equity market will thus have profound implications for Japanese capitalism. Pension fund trustees will have to pursue higher returns to meet their responsibilities. And this search will, in turn, compel corporate managers to change the way they do business.



By 2000, Japan's ratio of public debt to annual national output will probably exceed that of any industrial country since the Second World War.

A few companies are already giving managers incentives to respond to this challenge by introducing stock options linked to profits. But there is still deep hostility to the concept on the grounds that it promotes individual, over group, performance.

In any case, the crisis of Japan's pension funds demonstrates that corporate stakeholders' interests in profitability are far more complex than is generally understood. If corporations are to tolerate low profits in order to protect employees or suppliers, someone has to pay the piper. And with pension funds playing a larger role in allocating savings, the losers would inevitably include many retired people.

The economic slump resulting from problems in banking and corporate structure is producing a fourth crisis – this one in Government fiscal policy. Japan's public deficit will probably rise to 10 to 12 percent of G.D.P. this year, while the public debt will soon reach that of traditionally spendthrift countries, such as Italy and Belgium. By 2000, Japan's ratio of public debt to annual national output will probably exceed 140 percent, more than any industrial country since the Second World War.

The Government has traditionally been able to finance deficits by selling bonds to the state-controlled postal savings bank. With $2.5 trillion in assets, this institution is the largest bank in the world. It has a huge advantage in attracting household savings because it offers both insurance deposit protection and tax shelter.

Under the Japanese form of scrip, people use stamps rather than signatures to identify themselves. This permits individuals to maintain multiple identities for tax purposes. And since deposits up to 10 million yen at the postal saving banks are tax free, households often maintain more than one account. Indeed, there are 150 million accounts in a country with a total population of only 120 million.

But even the resources of the postal savings bank may be inadequate to cope with the Government's burgeoning funding requirements. The postal savings system's customers hold more than 100 trillion yen in high-yield deposits (taken out during the early 1990's, before rates fell) that will mature during the next year. Since the postal savings bank is worried that it will not be able to hold on to these deposits at the current low yields, the Ministry of Finance recently announced that the bank would purchase fewer Government bonds in 1999.

This shocked the market and caused bond yields to shoot up from 0.65 percent in the autumn to nearly 2.5 percent in early 1999. Since the Japanese bond yield last autumn was the lowest level ever recorded in human history (the previous low was 1.12 percent in Genoa during the early 17th century), it is not surprising that yields rose as the Government's funding requirement became apparent. But since Japan's inflation rate is a negative 2 to 3 percent, the upsurge in yields means that real long-term borrowing costs are now in the 3 to 5 percent range – very high for a country in deep recession. The surge in Government bond yields will, of course, also lead banks to raise interest rates on mortgages and corporate loans.

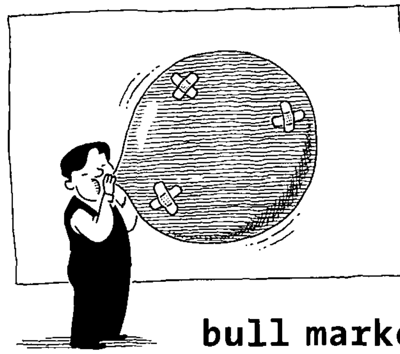
All this suggests there are limits to how far Japan can go in pursuing an expansionary fiscal policy. There have been numerous stimulus packages since 1992 focusing on both public works spending and tax cuts. These packages helped to cushion the decline in private spending. But the public debt is now reaching such high levels that it could cause bond yields to rise and thus undermine the benefits on the fiscal side.

DESPERATE MEASURES

Plainly, there is no simple way to revive an economy confronted by so many challenges simultaneously. Monetary stimulus that lowers interest rates has a limited impact on available credit because of the banking sector's problems. Low corporate profits lead households, worried about job security and pensions, to increase savings. Meanwhile, the Government's ability to spend will be increasingly constrained by the public debt and the risk it poses to long-term interest rates. The latest uptick in bond yields could also dampen capital outflows, causing the yen to appreciate and threatening export competitiveness.

The situation has become so desperate that the Bank of Japan has decided to lunge toward a highly aggressive monetary policy, lowering money market yields close to zero and expanding its purchases of short-term

Government debt. The banking crisis will probably prevent the zero funding costs from having much impact on domestic lending, but it could encourage more global borrowing in yen.



In 1997-98 there was an impressive expansion of yen borrowing by American hedge funds to finance speculation in third-country security markets. The highly publicized near-collapse of Long Term Capital Management in September 1998 caused the banks to curtail these credit lines and set the stage for a major yen rally as the hedge funds were forced to pay back the borrowed yen. But with Japanese funding costs near zero, there is likely to be a renewal of global yen borrowing that depresses the exchange value of the currency.

The fact that the Government is simultaneously injecting trillions of yen into banks through purchases of preferred stock should also increase the odds of monetary policy becoming more effective. When America's banks had capital problems after the real estate crisis of the early 1990's, one of the ways they restored profits was to expand their holdings of Government bonds. In those days, Government bonds yielded 6 to 7 percent while the banks could attract short-term deposits at just 3 percent. And the incentives for pursuing a similar strategy today have been increased by the new global rules that make it unnecessary for banks to back Government bond holdings with their own capital.

Japanese banks may be able to pull off a similar coup, since they can now borrow for practically nothing and then stash the funds in bonds yielding about 1.5 percent. Three months ago this yield gap was less than half a percentage point.

The case for a bull market in Tokyo is increasingly compelling because of the structural changes now starting in corporations.

At both the Davos World Economic Forum and recent Group of Seven meetings, American officials appeared to signal that they could live with a weaker yen if it led to a revival of the Japanese economy. The major risk posed by yen depreciation is that it could set off speculation against other Asian currencies and provoke China to devalue the yuan. But in contrast to 1997 and early 1998, many East Asian countries have recently experienced currency appreciation because the recession has depressed their imports and led to an accumulation of foreign exchange reserves. As a result Japanese officials themselves believe that Asia could live with a yen that fell back to a trading range of 130 to 140 to the dollar, provided the depreciation occurs gradually.

What remains unclear is whether even zero interest rates will produce a large depreciation in the yen. Japan is accumulating an awesome $15 billion a month in foreign currency reserves, and commercial banks are now controlling lending to hedge funds far more carefully. Meanwhile, the monetary easing could inspire a Tokyo stock market rally and cause foreigners to flock back into Japanese equities on the grounds that they are finally much cheaper than Wall Street.

Despite the poor outlook for the economy in 1999, the case for a bull market in Tokyo is increasingly compelling because of the structural changes now starting in corporations. When the recession ends, Japan will not simply be a country with leaner corporations poised to bolster profitability. It will be entering a new cycle of growth in which corporate decision-making and social values will be profoundly different. There will be a new structure of corporate ownership and financial relationships – one that compels companies to focus on profits.

This new Japanese corporate sector will offer both challenges and opportunities to outsiders. It will remain a formidable competitor. But the increased emphasis on profits will lessen its tendency to compete for market share through price discounts and excessive investment.

The dismantling of cross-shareholding, along with expanded foreign ownership, will also help to open the Japanese market. Today, a hefty share of foreign trade is conducted by the subsidiaries of multinational companies operating in different parts of the world. Since foreign companies own just 1 percent of Japan's capital, compared with 10 to 20 percent in the United States and Europe, imports are lower than would otherwise be expected. The current surge in direct foreign investment in Japan will thus lessen trade tensions, which have resulted from the profound differences in the corporate structures of Japan and other industrial countries.

SEA CHANGE

In the early 1990's, Eisuke Sakakibara, the high-profile vice-minister of international finance, wrote a book arguing that Japan had produced a unique economic system – one combining a market economy with corporate behavior that transcended capitalism (the non-capitalist market economy). This system, he said, was the byproduct of corporate relationships that resulted from Japan's closed financial system and indifference to profits.

When Japan agreed to open its financial system to global competition, it set the stage for unraveling these relationships and forcing far-reaching changes in corporate behavior. As Japan is committed to more open markets and acceptance of globalization, it will now have to embrace Western ideas about economic behavior that conflict with the Sakakibara model.

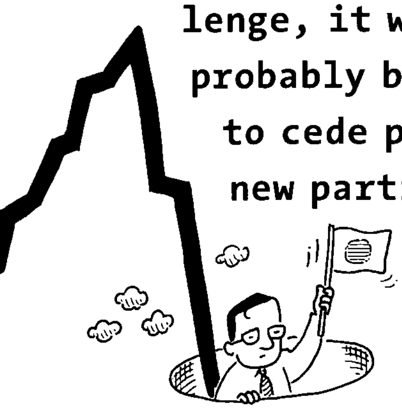
While Westerners often dismiss Japan's system of hierarchy based on seniority and lifetime employment as obsolete, it does create a sense of rights and responsibilities that produces a unique corporate consciousness and code of employee behavior. Recently, for example, former executives of some of Japan's newly nationalized banks refunded the bonuses they received at retirement. They are making the sacrifice on the grounds that they should take responsibility for their imprudent management. Just imagine an American or British banker making a comparable giveback.

One obvious implication of the upheaval in Japanese business is that the Government will have to replace the implicit corporate social safety net with an explicit public one. Tokyo must raise unemployment compensation and spend more aggressively on job retraining. Japan simply cannot afford a European-style welfare state because its ratio of public debt to national income is already close to Italy's, even as retirement funding costs mushroom. But if the Japanese public is to accept the social consequences of corporate restructuring, the Government will have to compensate the losers.

Nor can the Government stop with more generous jobless pay. It must also promote job creation in the service sector by accelerating deregulation and creating incentives for venture capitalists. As the United States economy has demonstrated, the best solution for replacing the jobs lost in restructuring large corporations is the rapid growth of small- and medium-sized enterprises.

Tokyo has tried to avoid restructuring by pumping cash into pork-barrel construction and by reducing interest rates to zero. But with such policy levers constrained by the public debt and the banking crisis, corporations themselves are being forced to bite the bullet. Recently, dozens of companies – most notably, Sony – have announced plans to reduce capital spending, promote voluntary retirements and divest unprofitable divisions. Some of the plans have been so momentous that share prices have rallied despite the simultaneous announcement of worse-than-expected profits.

If the Liberal Democratic Party leadership is unable to rise to the challenge, it will probably be forced to cede power to new parties.



The stock market senses that Japan has reached an economic turning point that could set the stage for a rebound in profits. But as the divergent experiences of America and Europe with restructuring will testify, the process cannot succeed in a political vacuum. The Government has yet to explicitly acknowledge the implications of restructuring. As unemployment breaches 5 percent this summer, Tokyo will have to show that it can manage the social consequences.

Japan's political system has seldom produced strong leadership in the modern era, the sort of leaders who can inspire public confidence. But with the stock market now poised to rally, the Government should have at least one economic indicator to use to persuade the public that the restructuring is essential to restoring prosperity.

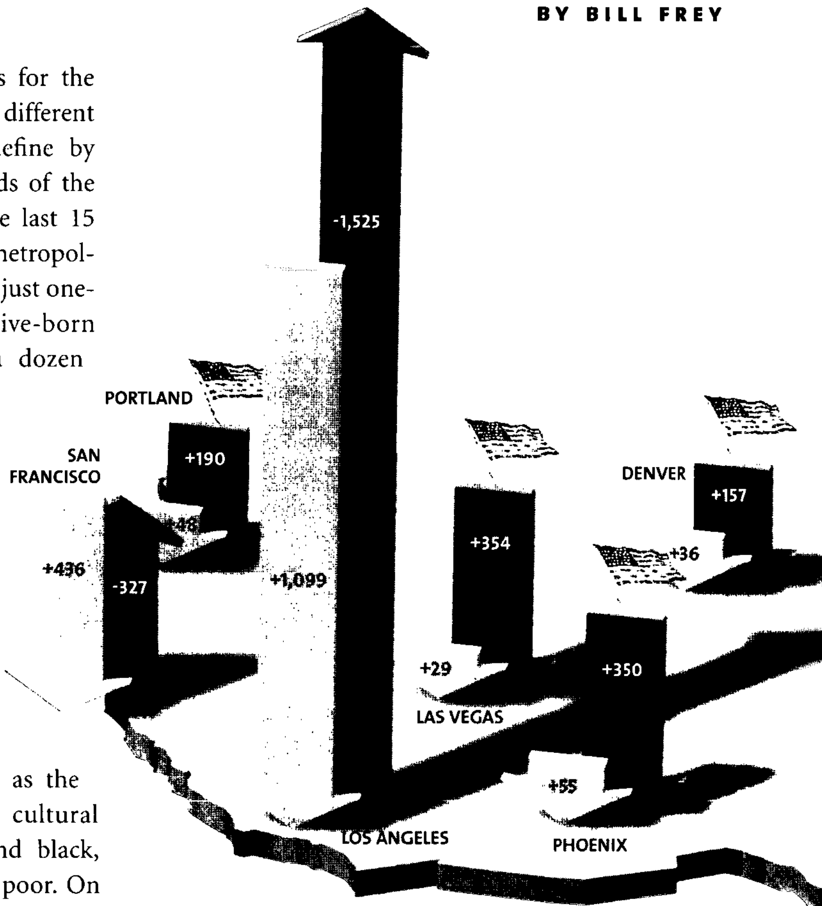
If the current Liberal Democratic Party leadership is unable to rise to the challenge, it will probably suffer major losses in next year's elections and be forced to cede power to a coalition of new parties. In fact, there could be a period of political uncertainty as Japan's parties come to terms with the fundamental changes in attitude that must accompany restructuring.

Japan will doubtless make its peace with western-style capitalism eventually. But in contrast to the past, Japan is now a very comfortable society. So there could be more social conflict and political turmoil during the next few years than previously seen. But outsiders should not regard such conflict as unhealthy or dangerous. It is the inevitable consequence of the most far-reaching shift in Japanese economic values since Commodore Perry opened the nation to the West nearly 150 years ago, ushering in the modernization known as the Meiji Restoration.

Remember the "melting pot?"

Or did you go to school when "mosaic" had become the optimistic metaphor for the way the newly arrived found their geographic and social niches in a nation built by wave after wave of immigrants.

BY BILL FREY



The immigration numbers for the past few decades tell a very different story – one harder to define by metaphor. About two-thirds of the immigrants arriving in the last 15 years are now clustered in metropolitan areas that are home to just one-quarter of the native-born Americans. Meanwhile, a dozen other rapidly growing cities have become magnets of opportunity for domestic migrants, creating increasingly concentrated pockets of the older, English-as-a-first-language white and black middle-class.

This new demographic divide may, in the end, be as significant as the existing economic and cultural chasms between white and black, rural and urban, rich and poor. On the one hand, a handful of cities are fast becoming multi-ethnic caldrons – showcases for the best and worst aspects of globalism. On the other, footloose, native-born Americans in search of better jobs and housing are creating more homogeneous metro sprawls.

Still looking for a no-muss, no-fuss label? Call it Balkanization, American-style.

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