

Japan's great hope

The country's maverick reformer, Junichiro Koizumi, now has a popular mandate. He must use it

“I WAS able to overcome the first obstacle” was Junichiro Koizumi's sober take on his election victory on July 29th. This was modest: his achievement was little short of astounding. In the three months since he became leader of Japan's Liberal Democratic Party (LDP), the wavy-haired, trendily clad Mr Koizumi, whose predecessor was driven from office by dismal opinion-poll scores, has notched up approval ratings of over 80% and translated them into an impressive 65% of the contested seats for his ruling coalition in the upper-house election last Sunday. Before he took over, most people had expected the coalition to lose its upper-house majority. Some even spoke of the extinction of the venerable LDP, which has held power for all but ten months since 1955.

Yet, Mr Koizumi's downbeat assessment was realistic too, because his real problems are now beginning. He actually has to do something to try to revive the world's second-largest economy, which has lain flat on its back for almost a decade, rather than just talk about it. This is hardly a propitious time to take the task on, given that the rest of the world — including, most notably, Japan's biggest export market, the United States — is also now in, or close to, a recession. For that reason, though, Mr Koizumi's success or failure matters more than for any recent Japanese prime minister.

The outcome will depend most of all on the LDP itself. Its dinosaurs, the ones who have steadfastly opposed ending the feather-bedding of privileged (and duly appreciative) groups like Japan's farmers, builders, utilities and banks, have been pretty quiet up till now; after all there was an election to win. But perhaps they have not really believed themselves to be under threat. After all, Mr Koizumi has been pretty vague about most of his reforms. And the dinosaurs know, as Mr Koizumi knows, that he won the LDP presidency against the wishes of most of his own parliamentary party (see pages 21-23). Yet, strong though the old guard is, Mr Koizumi has strength of his own. He is so hugely popular that it would be politically risky for anyone to be seen to be obviously frustrating his plan.

The pain won't hurt too much

Japan's political history is littered with the corpses of reformers, swept in a wave of hope only to be swept out again when those hopes were dashed. The voters may say they want change, but they have shown no great taste for the discomfort that tends to go with it.

Will Mr Koizumi fare any better than others before him? He has certainly not been shy about promising pain. Throughout the election campaign he has stressed his theme: “reform with no sacred cows”. And few would deny that sacred cows, herds of them, need slaughtering. A list would include the building industry, relentlessly protected and propped up by public spending, agriculture, also hideously protected, as indeed are service industries of all kinds. Perhaps top of the list would be the utilities, among the world's most expensive and cosseted, whose inefficiency throttles economic activity at every level.

Economic activity, however, will demand more than a wholesale opening up to competition. It will require, in particular, action on the country's huge stock of dodgy debt. The government itself says the banks have ¥150 trillions (\$ 1.23 trillion) in bad

or doubtful loans on their books. Yet Mr Koizumi has said little about what he would do about it. Current plans talk of dealing with only ¥13 trillion. A far more ambitious programme is needed, one that will in effect nationalise the unsound banks temporarily, while regulators hive off their bad loans and sell whatever good bits remain of the banks to help cover the cost. Until that happens, the normal lending and borrowing on which any economy depends will not resume, and neither households nor companies will regain the confidence to start spending money again.

Lots of pain; and a purge of the banks. It sounds worthy. But the risk is that this could just make a weak Japan even weaker, by intensifying deflation and raising unemployment. It is worryingly reminiscent of the early 1930s in America, when following the 1929 Wall Street crash the consensus favoured “liquidation” — ie, pain and a purge — accompanied by tight money in order to enforce “discipline”. What followed was the Great Depression.

...if everyone goes on a spending spree

That danger means that demand must also be boosted, even while Mr Koizumi's supply-side purge is under way. The rigidities in its banks, utilities and service industries are not Japan's only problem: as bad is a systemic deficiency of demand, rooted in the asset-price collapse in the early 1990s, since when some property prices have fallen by 80%. Individuals and companies who have seen their net worth so badly eroded save more and spend less.

Japan has already tried one kind of demand-management: vast extra spending on public works that have littered the landscape with roads leading nowhere, bridges no one crosses and airports that lie idle. About \$1 trillion has been pumped into the economy in this way over the past decade. An alternative way to stoke demand would be to cut taxes, but the scope for doing that is limited by the huge budget deficit, which stands at over 130% of GDP.

There is, however, another way to do it: a much looser monetary policy. Interest rates are at zero, and cannot be cut further. But the Bank of Japan could buy in much more government debt, reducing its stock and in effect printing more money. The problem is that its governor, Mr Masaru Hayami, is reluctant to do so on the scale required: he fears inflation, and thinks, like his 1930s American forebears, that loose money will erode the incentive for structural reform. It is Mr Koizumi's task to persuade him he is wrong. Failing that, he should seek his removal, pointing out that, independent though the bank may be, Mr Hayami has failed in his duty to achieve price stability. All this is a tall order for any prime minister, not least one whose relations with his own party are still evolving. But unless Mr Koizumi is bold, Japan's deflation will continue, and with it today's national despair. ■