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US Scholars' Declaration on Japanese Reform

The following is a declaration issued October 25 by a group of US specialists on Japan. The declaration came out of series of meetings that were convened at Harvard University by Professor Ezra F. Vogel. The statement was drafted by William H. Overholt, Asia Policy Chair, Rand Corporation. The other participants in the meetings who signed the statement include: Richard N. Cooper, Professor of International Economics at Harvard; Richard Katz, Senior Editor, The Oriental Economist Report; Jon D. Mills, Manager, Harvard University Asia Center; Hugh Patrick, Professor of International Business at Columbia University; and Michael Y. Yoshino, Professor of Business Administration at Harvard. The scholars group is completely independent from any US government agency or business group.

The specialists believe that the Japanese economy has potential to continue its extraordinary past achievements but that strong, painful bank reform and company closures costing a few million jobs will be necessary to avert calamity. The specialists stressed that, in order for such strong action to be politically and economically feasible, its depressive effects on the economy must be offset by monetary stimulus and sizable tax cuts. In addition, a strong social safety net, including beefed up unemployment insurance, is required.

We are scholars who have been studying Japan for several decades and admiring Japan's remarkable achievements. But the Japanese nation has now come to a moment of decision. It can choose rapid, painful reform leading to rejuvenation, or it can choose marginal reform leading at best to stagnation. Status quo policies would ensure eventual calamity.

We speak with humility because we know the US experienced a financial squeeze. We speak with humility because the advice Americans have given to Japan has not always been good advice. But we speak with urgency because the Japanese financial crisis is potentially grave. Our views are independent and have been formulated gradually over the past year.

There are times in a nation's history when the virtues of one period make it difficult to achieve transition to another. In all democratic countries it is often difficult to achieve consensus to take the bold action that is good for a country in the long run. It is particularly difficult when, as in Japan today, life for most remains prosperous. However, Japan's seeming prosperity masks problems that could cause great suffering. Japan's youth lack a future. The middle of Japanese society is being squeezed. This crisis is politically insidious. We therefore write urgently to declare our support for those who advocate decisive early structural reforms.

We believe that the Japanese government can once again position itself as a world leader and that it can continue to provide its people with one of the world's highest living standards. The educational achievements of the Japanese people rank among the world's highest. Japan's technologies in areas like automobiles and consumer electronics are superior to those of anyone else. Japan has a disciplined and talented work force together with production management techniques that have rightly been copied all over the world. Japan's national unity is the envy of most of the world.

The whole world, including ourselves, will benefit from Japanese rejuvenation. The whole world, including ourselves, will suffer if Japan descends into crisis. As American friends of Japan, we have the greatest interest in a Japan that is growing, financially sound, and a proud world leader.

However, the current financial situation threatens to become grave. By almost any accepted private calculation, the liabilities of the banks substantially outweigh their assets, and the liabilities of the government probably also outweigh its assets. A wide range of companies is unprofitable and has no prospects of becoming profitable. This means that bank accounts are not worth in real terms what they seem to be worth, that pension promises are not worth what they seem to be worth, and that many jobs are inevitably going to be lost.

Reform cannot avert these consequences, but reform can minimize them. If reform is delayed, the problems grow exponentially. Bad loans grow with compound interest or become more burdensome with deflation, and because of that the bankruptcies and job losses grow exponentially. Keeping deadbeat firms alive worsens overcapacity and deflation, thereby killing other companies. Therefore reform without delay is essential.

Japan's current problems result only in part from the bubble deflation of the early 1990s. The principal cause is the ongoing failure to use Japan's extraordinary resources efficiently. According to the most authoritative private estimates, Japan has the equivalent of about one trillion dollars tied up in companies with no hope of recovery and an additional one trillion dollars tied up in companies whose prospects for profitability are quite limited. Many of the country's best workers are stuck in unproductive jobs because the companies they work for are obsolescent and the lifetime employment system makes it difficult for them to move. In addition, a network of domestic and international protections has created a "high cost economy" that is uncompetitive itself and drives Japan's most efficient companies to move to countries where the high cost economy will not affect them.

As long as such vast resources are squandered, Japan's economic and financial situation will worsen. Once such resources are restored to efficient use, the living standards of the Japanese people and the international stature of Japan will resume their previous rise. Fixing the banks alone will not accomplish this. Resources must be withdrawn from inefficient companies and put to new uses. Forgiving loans to failed companies usually worsens the fundamental problem of resource misallocation.

Many Japanese strengths must now be modified to adapt to new circumstances. Government leadership of business must give way to more private initiative. Companies that have been committed to their employees through lifetime employment need to find ways of adapting to new economic circumstances. Institutions like amakudari that ensured business-government collaboration must give way to arms-length market transactions.

The bankruptcy of many firms, the associated loss of jobs, and the drastic reallocation of government expenditures, constitute a serious wound for society. We do not wish to underestimate this wound; indeed we are so concerned about it that we recommend emergency action to prevent it from becoming bigger. Because it is a serious wound, both government and business must urgently devise more effective help for those who lose jobs. Job security has previously provided a social safety net; now Japan needs new kinds of safety netting.

While the social dislocation will be painful, experience elsewhere has shown that, when labor and capital become much freer to move, unemployment spikes up quickly and then falls quite rapidly. When capital and good workers are released from failed companies, they move to better companies and start new companies. The pace of employment recovery in places as diverse as Sweden, China, and South Korea has been remarkable.

Bailing out failed companies is almost always not just bad economics but also bad social policy. Keeping workers and money tied up in bad companies destroys the future. Saving five jobs now can easily cost ten jobs later. Working in a dead company deadens the spirit. Working in a new company creates a sense of opportunity and excitement. South Korean and Chinese companies and banks had much worse problems than Japanese ones, but today Chinese and South Korean cities are pervaded by a sense of energy and opportunity.

As Americans, we are particularly conscious that the US experienced a banking crisis and a crisis of competitiveness in the 1980s. At that time, Japanese competition stirred reform, and Japanese views and practices prodded US policies. The Japanese crisis is much bigger than the American one, but the US crisis provides important lessons. After the stressful adjustments of the 1980s, including many bankruptcies, vast structural adjustments, and expensive bank failures, US industries became revitalized, the banking system became more efficient, and new industries, especially high tech, benefited. This shows that the experience of revitalization through more efficient resource use is not confined to countries that are poorer than Japan.

Bankruptcies may be phased, but rapid change is essential. It is disastrous when new bad loans emerge faster than old ones are removed. Only through freer movement of labor and capital can a country gain the benefits of the entrepreneurial spirit that has so energized other countries that have reformed rapidly. The government will undoubtedly want to provide general guidelines on the phasing of bankruptcies, and it can do this by phasing the pressure on the banks to clean up their bad loans, but only the market can make the detailed decisions efficiently. Otherwise, every bankruptcy will become a political battle and the reallocation of resources will be neither speedy nor efficient. Bad assets must be auctioned off quickly to redeploy the nation's assets, not warehoused by institutions like the Resolution Collection Corporation.

Capital must be redeployed by an efficient financial system. Today's crippled banks cannot do that effectively. The government needs to close some banks and recapitalize others. Those that are recapitalized need new management. Old managements always have an incentive to minimize the problems and defend old ways of doing things. New managements have an incentive to confront problems, being able to blame them on old management, and to demonstrate emphatically that they have abandoned old ways and adopted modern ones. The United States and South Korea are among the economies that have benefited enormously from ruthless change of failed bank managements. Japan, Taiwan and Thailand have suffered malaise throughout the whole society as a result of protecting old managements. The Japanese people deserve a renovated banking system.

There has been extensive debate over the priority between structural reform and fighting deflation. Those who would give priority to fighting deflation say that the nation cannot tolerate a deflationary spiral that worsens debt and deters consumers from spending. They are correct. But zero interest rates in the absence of reform just subsidize banks and companies to carry their bad assets rather than reforming them; the bad assets and waste of capital then worsen exponentially. And spending on more construction projects in the absence of reform just worsens the waste of resources; Japan now has even more construction workers than it did in 1990, and it already had twice as many as it needed in 1990. It is not true that most companies' inability to pay is caused mainly by deflation; many companies were failing long before deflation began.

Those who would give priority to structural reform say that the nation can never grow properly until the banking system is healed and resources are used more efficiently. They are correct. But structural reform cannot succeed in the context of a deflationary spiral.

Japan therefore must both reform and stimulate, simultaneously and urgently. Fighting deflation does not require delay of structural reform. In fact, the Asian countries that have done the most decisive reforms, South Korea and China, have shown more vigorous economic growth than their slower-reforming counterparts like Taiwan, and they have successfully contained deflationary pressures.

There is a prevalent myth that structural reforms, with the inevitable bankruptcies and layoffs, are inconsistent with fighting deflation. The opposite seems to be true in neighboring countries. So long as there is no clear plan for remedying the economy's desperate structural problems, businesses and consumers remain anxious. The country's youth lack a future, the mature lack a sense of purpose, and the middle of society gets squeezed. Businesses see no opportunities for investment. The future seems to hold only devalued pensions, devalued homes, and a struggle to maintain what one already has. A once vigorous workforce becomes demoralized, and anxiety reduces expenditures, crippling the economy. Conversely, decisive action, even if painful, gives hope and encourages investment and spending.

Many people worry about the Japanese government's big deficits and the resultant huge debt, and they want to cut the deficits immediately. But an economy in a deflationary spiral will eventually force even bigger deficits. Hence Japan must stimulate while it reforms. The key is to do the reforms promptly so that the period during which stimulus is necessary will not be unduly prolonged. When the economy uses its capital more efficiently, faster economic growth will increase tax revenues and the deficit will decline.

The reformist task of allocating resources efficiently would be greatly facilitated if the government changed the way it stimulates. Instead of spending more, the government should tax less. That way, the money will be allocated efficiently by the market.

Stimulus through devaluation will not solve Japan's problems. Such stimulus is temporary and comes at great cost to Japan's neighbors. Devaluation avoids the necessity to reallocate capital and labor more efficiently, and further delay in that reallocation is potentially catastrophic.

The Japanese economy needs stimulus, structural reform, a new safety net, and transparency. If these reforms are implemented decisively, the nation's extraordinary resources will be used more efficiently and confidence will revive. As a result, Japan will grow and its financial problems will gradually decline. We reaffirm our belief that Japan, with its educated people, disciplined workforce, and innovative technologies can compete successfully with anyone in the world if the nation's resources are used efficiently.

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