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Perspectives

Japan's Swan Song



In his first public statements, Japan's new Prime Minister, **Junichiro Koizumi**, has vowed to change all. "My job is to carry out reforms that were taboo, that weren't possible before," he says. "All those Liberal Democratic Party legislators who didn't support me said they didn't know if the Koizumi cabinet could survive even a month...well, now they've got to support me, like it or not."

What makes Japan's 11th prime minister in 12 years think he's different? Two things are in his favor. The first is that Japan has been deprived of any measure of economic success for several years. Financial markets are in the tank, and the country is arguably the most indebted industrialized nation in the world. Second, Koizumi's reformist ideas enjoy enormous popular support; according to opinion polls, he has the backing of 80% of the electorate!

On the other hand, I can think of several recent prime ministers whose promises of change were equally well liked. Yet only months later, the majority of Japanese brushed them aside as corrupt and incompetent demagogues—no different than their predecessors. In Japan, grand visions for change are extremely difficult to get off the ground.

Debt beyond imagination

Even in the West, most people are aware of the primary reason: a deeply entrenched arrangement between special interests, in which the Liberal Democratic Party, civil servants, a handful of corporations and organized crime exchange favors. Time after time, economic rescue plans have concentrated on largely unnecessary infra-structural spending, leaving the nation more deeply in debt, even to its own consumers. Over the past ten years, over 80% of the increase in household savings has been lent out to the government by the financial institutions consumers trusted. Government debt currently stands at 130% of Gross Domestic Product (even worse than Italy in the bad old days) and currently contemplated reform actions could take it well above 150%. Moreover, analysts estimate that if unfounded pension liabilities are included, the country's public sector debt is closer to 300% of GDP!

No wonder the Japanese people are ready for a change, or so at least they think. However, there are compelling arguments that, in the end, the people are the biggest stumbling block for true reform. **David Roche**, the president of **Independent Strategy**, a London based investment consulting firm, articulates this problem well when he says that: “there is little awareness of the pain reform will cause.” Roche points out that when it comes to switching political and social models in a Democratic society (which a major change in economic models always entails), the “*either-or* principle applies. *Either*, you, the voters, accept the pain or reform, *or* the pain of not doing so will be even greater.” Roche is betting that Japan lacks the *either* and the *or*. “Its citizens believe there will be no pain from the reform, only gain. When they realize the truth, the backlash against the reformers could be considerable.”

I agree. Although Japan is not my specialty, rather something I watch with fascination from afar, the country’s continued descent into protracted chaos appears inevitable. Personally, I’m not even sure whether Japanese voters will ever get a chance to question the reform process. The special interest lobby appears so powerful that I have to wonder whether the new prime minister’s expectations aren’t incredibly naïve.

There is also the cultural factor. Japan is a nation which is not only in denial of its own history, but which whitewashed its imperial family and the business interests that got it into utter defeat at the end of World War II. What makes anyone think that the same nation can now accept that the vast majority of its entire political, business and intellectual elite is corrupt and complicit in the fraud that has brought its legendary postwar prosperity to an end? Unfortunately, unless that happens there’s little chance of anything changing.

No one cares about Japan...

What are the implications of Japan’s continued descent for the industrialized West? Not pretty, I’m afraid. The foreign policy platforms of most major nations have already been adjusted. The US, the European Union and others are placing almost all their bets on China. This, in itself, is deeply offensive to Japan and will not only speed its isolation but may also add momentum to its decline.

Foreign investment in Japan reflects that. Three years ago, Western corporations demanded greater access to Japanese markets (something that might have helped Japan, but which the politicians fought tooth and nail)—now, most global businesses are quietly pulling back. Money managers, too, are pulling in their horns: new foreign investment in Japan is drying up, while existing holdings are being liquidated. My daughter, who’s an analyst and works for a major bank, captured it all when I shared my fears about Japan with her not long ago. “No one cares about Japan any longer,” she said. She was absolutely right: to the latest generation of money managers and executives, Japan has become a non-entity that exists only on the fringe of their universe.

...but Japan’s problems will affect us all

But while the markets ignore Japan, our politicians shouldn’t. The country’s problems, if aggravated further, will almost certainly affect us all. Several US and European banks still have significant exposure to Japan and, more importantly, Japan still holds huge quantities of US Treasury debt. A collapse of Japan’s banking system would almost certainly cause large-scale liquidation, with an attendant fall-out in world financial markets that is hard to envision.

A political deep-freeze between Japan and the US could have similar consequences. It’s difficult to imagine that the Japanese will keep buying US Treasury bills and bonds as the country’s relationship with the US sours. Perhaps the Chinese will jump in; perhaps they won’t.

For several reasons, these are longer-term concerns. Right now, the prospects for a sharply lower yen and the reality of Japanese interest rates close to zero make the dollar an attractive place, as does the stark fact that there is no true alternative to the dollar. But things change, and the growing possibility of a Japanese-inspired crisis in world financial markets looms. □

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