# Why Japan Can't Reform

*Only a drastic crisis can transform rhetoric into action.*

BY GENE DATTEL

The focus on current Japanese currency and stock market gyrations is titillating. After two decades of hibernation, Japan's economy briefly became front page news. A high-octane monetary printing press, a fiscal spending spree, a quarterly 3.5 percent growth rate, a 70 percent stock market spike, and the ensuing stock market correction provided media drama.

But the key to Japanese long-term economic success lies in structural reform, not in manipulation of money supply or short-term stimulus fixes.

Can Japan institute real change? Why has the call for reform lasted for decades without result? For the last twenty-five years, I have consistently argued in this publication and others that Japan would not deal with its structural problems. The root cause of its economic malaise is societal and therefore highly resistant to technical solutions which infringe upon traditional behavior.

The critical economic logjam is caused by regulatory and cultural factors. Among the foremost obstacles is Japan's ineffectual financial apparatus. At this stage of development, Japan's financial institutions are incapable of either promoting innovation or purging uncompetitive elements within Japan's economy. Finance is the mechanism by which much of the needed reform would be implemented.

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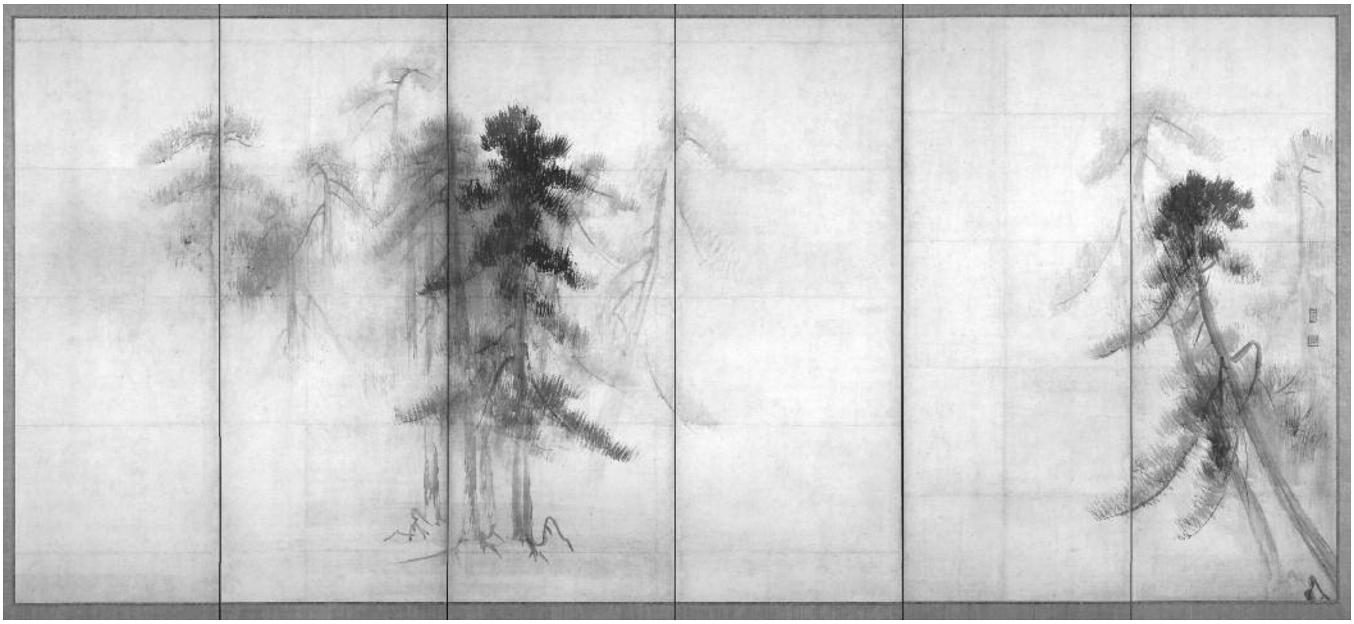

*Hasegawa Tohaku, Pine Trees. Momoyama Period, 16th century.*

Prime Minister Shinzo Abe's massive injection of money and fiscal stimulus were his first two "arrows" aimed at Japan's lethargic economy. Abe added a third metaphorical arrow to ensure long-term growth. This third arrow—structural reform, meaning large doses of deregulation—created little media excitement.

As details emerge even after his recent election mandate, there is no indication of broad restructuring. Abe has announced marginal changes. His unimposing list includes encouraging pension funds to purchase foreign equities, supporting the addition of independent directors to corporate boards, and instituting a few corporate tax breaks. No overhaul of Japan's restrictive labor market is contemplated.

The seeds of Japanese problems were evident during my sojourn in Tokyo during the 1980s as market participant and advisor to the financial sector.

Reform has been just around the corner since the phantom Japanese juggernaut of the 1980s sank and the perceived threat to America vanished. "Japan's Struggle to Restructure" was the title of a 1993 *Fortune* magazine article. Yet in the same year, Eisuke Sakakibara, a senior official at Japan's Ministry of Finance, warned against reform that would bring American-style deregulation. In his 1993 book *Beyond Capitalism,* Sakakibara wrote that American-style deregulation would lead to "a wider gap in income distribution, rampant money worship, and the vulgarization of culture."

For Sakakibara, Japan had transcended capitalism—hardly an endorsement for reform. The lauded formula included government/private sector partnerships, a highly centralized government, powerful bureaucrats, and social cohesion. Big government activists used Japan as an ideological stalking horse beckoning America to a highly regulated promised land.

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Today's commentators seem to either have amnesia or no knowledge of the ongoing rhetorical flourishes about Japanese reorganization. In 2001, the foreign press anointed the then-newly elected prime minister, Junichiro Koizumi, as the messiah of modernization. By 2002, the foreign press had dumped the ineffectual but charismatic Koizumi. Japan even sponsored a roundtable with U.S. leaders to generate ideas to cure Japan's malaise. Nothing materialized.

The Nikkei index peaked near 39,000 in December 1989, and the recent high is still down over 65 percent in twenty-three years. Pundits were seduced by Japan's mirage of invincibility in the 1980s. But warnings of a culture clash with economic implications began earlier. By 1935, Wallace Donham, dean of the Harvard Business School, alerted the American readers of the popular magazine *Saturday Evening Post.* "Our Western civilization," Donham cautioned in "Japan Advances," "is the target of

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an Eastern Archer." The archery metaphor has had real staying power!

Japan's putative superiority entered the popular world of fiction and cinema through Michael Crichton's 1992 novel *Rising Sun.* The novelist listed his non-fiction sources—later shown to be alarmist and inaccurate—to reinforce fears of a Japanese economic assault.

*Japan can't implement structural reforms without shredding the very fabric of Japanese society.*

During the 1980s, American financiers invaded Japan and prospered enormously from the huge cash accumulated by their financial institutions. More importantly, inefficient, highly regulated markets provided an even larger profit bonanza. Visible U.S. private equity firms and hedge funds descended upon Japan. Alas, the Americans did not alter Japan's economy.

Even as Japan stumbled, Japan's admirers clung to the nation's exaggerated reputation for adaptability. No change occurred.

Currently, hedge fund manager Dan Loeb's attempts to separate Sony's profitable divisions from its money-losing ones have been rejected by Sony Chairman Kazuo Hirai. Although a symbol of Japan's manufacturing prowess, Sony, founded by entrepreneur Akio Mori, is not part of the establishment. Interestingly, Mori criticized the heavy hand of American financiers whom he dubbed "shufflers of paper" in a 1990 address at Yale University. In any event, Japanese industry would not be transformed by Sony's fate at the hands of Mr. Loeb.

The Western press has cheered structural reform. Foreigners are always either praising or hectoring Japan. The *Wall Street Journal* published a laundry list of recommendations: loosening of the time-honored tradition of lifetime employment, withdrawal of protection of small stores in deference to large retailers, removal of agricultural subsidies, and cleansing zoning regulations to free real estate developers.

Ironically, as Japan is being urged to tack towards the U.S. system, the U.S. is navigating into a sea of regulations. The broad powers of Dodd-Frank's regulatory approach eerily resemble Japan's system that is largely responsible for the country's anemic growth.

Japan simply can't implement genuine structural reforms without shredding the very fabric of Japanese society. The economic pitfalls of lifetime employment may seem obvious to an American, but Japanese expect to be protected from the perils of unemployment. Each deregulatory action would corrode Japan's deeply embedded paternalism.

Here, it is important to understand culture and the misuse of analogies—particularly the distinction between the United States and Japan. Foreigners and Japanese both revere Japan's unity, harmony, and lack of confrontation. All of these are possible because Japan is a closed society, permeated by conformity. Japan's homogeneous, hierarchical society is reinforced by a miniscule presence of ethnic minorities. Immigration is not part of the Japanese vocabulary.

Japan and America represent systemic and cultural extremes—contrasting civilizations. Diversity and openness on an American scale is absolute anathema to the Japanese mindset. This tightly knit nation shows no outward signs of discontent despite the so-called "lost decades" of feeble growth. Corrosive stagnation has yet to penetrate the façade of Japanese stability.

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A persuasive argument can be made that a country like America needs challengers who confront the establishment in the cause of innovation and purging (and profit). Deregulation is the prerequisite for this type of competition. Reliance on entrepreneurship, both financial and otherwise, requires an open materialistic environment, albeit accompanied at times by wrenching labor and financial dislocations. The very essence of Japanese culture would be severely tested if deregulation were seriously attempted.

Abe's third arrow, yet to be fully defined, accepted, or implemented, may not garner headlines, but the long-term economic future of Japan may depend on a political bullseye. First indications are for a repetition of past bold statements followed by the reality of *status quo.* Only a drastic crisis could force the Japanese to translate rhetoric into action. ◆