Lessons Learned and Advancing the US-Japan Relationship in Troubled Times

FEBRUARY 2009

Global financial turmoil combined with calls for new ways to manage an increasingly interdependent global economy are just two of many trends requiring companies, nations and consumers to reexamine previously held assumptions concerning their place in the world.

The US-Japan relationship and long-term partnership is especially important in this context. As the world’s two largest economies, their ability to work together will have major implications -- not only in promoting global economic recovery -- but also in efforts to maintain growth and development in an increasingly integrated Asia. It is also important in efforts to redefine multilateral systems and institutions moving forward. That is true -- not only in respect to the bilateral relationship -- but also to interactions between US and Japanese firms, financial institutions and investors as well as other entities around the world.

Fortunately, the US and Japan possess a deep mutual commitment to democracy, pragmatism, hard work and education. They also enjoy an increasingly vibrant cultural exchange. Their shared dedication to technological innovation and working together on international trade, investment, finance and other areas of shared concern, all provide a strong foundation on which to enhance cooperation moving forward. This can help to restore global economic growth and recovery in both nations. It can also advance the multilateral consensus necessary to address important issues such as energy independence, the environment, national security, poverty, health and other key policy challenges.

The inauguration of U.S. President Barack Obama as well as change in Japan -- marks a good time to reevaluate the US-Japan relationship. This reexamination will help to identify not only “lessons learned”
that allow a better understanding of present economic difficulties -- but also new ways this key driver of global growth might be utilized during these troubled times.

**Examining Current Turmoil Within Context of Japanese Experience**

Commonly-held assumptions concerning the underlying strength of the US economy, as well as the emergence of the BRIC’s and the theory of their economic decoupling were all severely tested last year. Similarly, the failure of major financial institutions, the excessive use of leverage and dramatic falls in most of the world’s capital markets have led to major declines in global confidence.

To understand this crisis and determine optimal policy responses, many analysts have compared current turmoil in the US to the collapse of Japan’s bubble economy in the early 1990s.

**The Collapse of Japan’s Bubble Economy and its Long-Term Effect**

Japan was on top of the world in the late 1980s. For three decades its economy grew at record rates and companies such as Toyota, Sony and Panasonic dominated the automobile and electronics industries – driving innovation and new management techniques that were the envy of the world. Confidence rose, money became easier to borrow and from 1985 to 1989 Japan’s Nikkei stock index rose 200%+. This led to a larger market capitalization than the US -- and some said the land under the Imperial Palace was worth more than the entire state of California.

When the bubble burst in 1990, the Nikkei dropped about 70% in two years and commercial land values fell about 80% in a decade. Companies could no longer repay loans secured by these assets, triggering a banking crisis. Despite government injections into troubled financial institutions, the real economy languished. Between 1990 and 2005 annual real growth averaged 1.3% -- the slowest pace of major OECD countries. In contrast the US enjoyed its longest postwar boom and China a highly impressive 10%+ performance.

To stimulate economic activity, the Japanese government slashed interest rates to about 0%, where they have remained for almost six years. They also allocated hundreds of billions of dollars
to eight or more public works programs. In late 1996, the Japanese government also initiated an ambitious "Action Plan for Economic and Structural Reform". This led to major change and adjustments -- including dramatic declines in corporate share crossholdings and a shift away from Japan’s lifetime employment system. Since this time, the proportion of workers with part-time or contract status has almost doubled from 21% to 41% and unemployment almost tripled from 2% to about 5.5%.

**What Lessons Can the Japanese Experience Offer the US Today?**

Given Japan still suffers from depressed valuations, rising public debt, and caution on the part of consumers and investors -- almost 20 years later -- many now ask whether the US will endure a recovery of similar duration. For now the consensus seems to be the US is moving faster to deal with its problems. This can be seen in a report by Tokyo-based analyst Richard Jerram of Macquarie Securities who noted “the speed and aggression of the US response gives hope that it will avoid following the path of Japan in the 1990s.” The reason is reflected in comments by Akio Makabe, an economics professor at Shinshu University, who stated in the New York Times “Japan had years of trial and error to gets its response right, but the US doesn’t have that kind of time . . . .”

Actions by US and other governments are described by S&P analyst Naoko Nemoto in a report titled Japan’s Lost Decade Offers Lessons for Current Global Turmoil noting they are taking “broader and faster action than the Japanese government did in the 1990s, which is clearly a good thing”. This includes substantial monetary stimulus and programs to deal with troubled mortgages, loans and companies, as well as the recovery program now being developed by the Obama administration. In addition, public works and clean energy programs and other initiatives may require up to $1 trillion in public expenditures. President Obama’s key focuses – education, infrastructure, energy, and health care – resemble a modern version of FDR’s New Deal and seeks to generate four million jobs and enhance US competitiveness.

**Japan Faces its own Economic and Social Challenges**

Japan suffered through four recessions during the “lost decade” of the 1990’s before returning to normalcy in 2001. The Nikkei index more than doubled from April 2003 to June 2007 as
investors assumed greater exposure and the nation experienced its longest period of growth since World War II. The global slowdown that emerged last summer, however, did not bypass Japan. The nation just entered its fifth recession – with consumer confidence at its lowest levels since 1982.

Part of the reason for this downturn is that domestic demand never fully recovered. Japanese Economy Minister Kaoru Yosano highlighted this dependence in a BBC article stating “The downtrend in the economy will continue for the time being as global growth slows …. (and) …. we need to bear in mind that economic conditions could worsen further as the US and European financial crisis deepens, worries of economic downturn heighten and stock and foreign exchange markets make big swings”. Further emphasizing this problem, Takeshi Minami, chief economist at Norinchukin Research Institute stated “The risk of Japan posting a third or fourth straight quarterly contraction is growing, given the fact we can no longer rely on exports”.

**Japan Enters Recession Despite Real Achievements Over Past Two Decades**

The weakness now seen in Japan has occurred despite the major restructurings, reorganization and deregulation that have served to transform the Japanese economy over the past two decades. This has vastly improved its physical and business infrastructure and created a more competitive business environment.

Initially outlined in late 1996 as broad goals within Japan’s “Action Plan for Economic and Structural Reform”, these objectives motivated government and industry to improve corporate governance, introduce deregulation, and reduce the cross-shareholdings that entrenched management in favor of a more shareholder-friendly orientation. Over time Japan’s Ministry of Economy, Trade and Industry built on these efforts, developing a New Economic Growth Strategy, that serves both foreign and domestic investors and other stakeholders. This includes policies and actions to enhance innovation and demand, stimulate local economies and improve Japan’s human resource skills and underlying capacity. Given enhanced growth and integration within Asia, Japanese firms have also been expanding their presence in the
While steps taken by Japanese decision-makers have the potential to increase domestic economic activity and to relieve its excessive reliance on exports -- there are important structural reasons why external activity will remain critical no matter what happens in Japan itself.

**Structural Factors Require Japan Increase Economic Activity Outside its Borders**

The most important factor is demographics. Japan benefited from a population boom after WWII. However, due to an aging society and low fertility rate, Japan’s population has been declining since 1998. This is true even in terms of people in the labor force, and by 2020 people aged 20-34 years are expected to decrease by 31%. One analyst, Don Coxe, Global Portfolio Strategist of BMO Capital Markets, pointed to the aging problem in a recent conference call noting this was a key issue for all developed markets. Given the problem was most severe in Japan, Coxe stated he was not surprised Japan’s Nikkei index had suffered an even greater decline last year than key indexes in other developed markets.

While Japanese policymakers are seeking to address this problem, according to the New Economic Growth Plan, “Even if the low fertility rate trend turns upward right now, significantly positive effects on the economy could not be expected for the next few decades. The effects caused by the low fertility rate, an aging society, and the population decrease must be viewed as preconditions locked into the economy for at least several coming decades.”

Given Japan is a country with few natural resources – the environment and energy are special concerns. For this reason extra attention is being devoted to developing new technologies and techniques that enhance the use of green and renewable energies, conservation, energy-efficient infrastructure and recycling.
Fortunately, Japan possesses the financial capital, corporate capabilities and intellectual capacity needed to manage this transition.

**The Evolving Context of the US-Japan Bilateral Relationship**

Over the past sixty years the US-Japan bilateral relationship has gone through several phases. Following WWII, the US helped rebuild the Japanese economy. Its industry recovered, regaining its underlying strength and the nation became a strong ally of the US in the region.

As Japanese companies began to compete more directly with US firms, an otherwise close alliance became strained. Combined with a number of high profile but ultimately unproductive investments -- many in the US began to see Japan as a challenge to its own economic strength. Given the resulting economic dislocation, this period of “Japan-bashing” was characterized by a number of trade wars and tense diplomatic negotiations between the two nations.

Ultimately, the collapse of Japan’s own bubble economy, a rise in US economic productivity, and steps by Japan to open its own economy and locate factories and employment in the US, helped to alleviate these concerns. This lead to a much more benign “Japan-passing” phase, where most US government and corporate leaders did not concern themselves much with Japan-related issues -- preferring to focus on China and other emerging low-cost economies.

For this reason during the Bush years much of the bilateral discussion between the US and Japan focused on security issues. This included support for the global war on terrorism as well as planning for regional contingencies, such as crises on the Korean Peninsula and the Taiwan Straits. Given the ascendancy of economic issues, however, as Tobias Harris wrote in a recent edition of the Nelson Report, “The challenge for the Obama administration is to present .... a vision focused on more than security cooperation. The security relationship is important, but it cannot be the whole of the U.S.-Japan relationship.”
The Potential for Enhanced Cooperation between Japan and the US

Part of the reason for this more tranquil relationship is that Japanese firms learned from their past experience. After the trade wars and unfavorable reaction over high-profile trophy investments made in the 1980s and early 1990s, Japanese firms became major employers in the US -- expanding their activities and investments in real assets and facilities and their involvement in local communities. One has only to look at the favorable reaction to Mitsubishi UFJ’s 2008 purchase of a 21% stake in Morgan Stanley against Mitsubishi Estate Co.’s 1989 purchase of Rockefeller Center to see how times have changed.

Additionally, Japan has long been a major buyer of US fixed income treasury securities and one area where Japan can provide support is US government efforts to borrow at least $1 trillion in 2009, excluding the US Treasury’s $700 billion plan to bail out the financial and other industries. Given $3+ trillion is invested in the Japanese postal savings system alone earning extremely low returns -- some analysts believe they will also expand their purchases of corporate bonds and equities as well.

Japan remains the second largest holder of US treasury securities, though fears over a surging yen have contributed by one estimate to a $193.8 billion reduction in Japanese treasury holdings in 2008 -- an amount that exceeds the entire holdings of the oil exporting nations. For this reason, some economists in Tokyo are calling for the issuance of “Obama Bonds” denominated in yen and other currencies. Issuing foreign currency-denominated US treasuries is not new. The Carter administration, sold “Carter Bonds”, denominated in German marks and Swiss francs to counter the effects of the two oil crises of the 1970s. Highlighting this concern, Kazuo Mizuno, chief economist in Tokyo at Mitsubishi UFJ Securities Co. stated in a recent Asia Times article that “The US will be forced to issue foreign currency-denominated US Treasures in its hour of need ... (it) cannot finance its deficit by itself.”

Growing acceptance and appreciation for Japanese investment in the US provides a
foundation for still further cooperation – including efforts to assist in US economic recovery efforts. Japan’s strength as a capital-surplus economy will prove an asset in this regard -- while also providing the growth opportunities it needs to position for the future.

**Japan Can Benefit By Facilitating a US Economic Recovery**

This view can be seen in comments by Kotaro Tamura, a Japanese legislator and former investment banker, in a Christian Science Monitor article. He notes the financial crisis represents “a huge opportunity for Japan” , stating “Cash is king right now, and we have a huge cash pile … We should invest in Korea and the US, help rescue them, and we would get economic and diplomatic returns”. In the same article Hiromichi Shirakawa, Credit Suisse chief economist for Japan notes “Japan has big foreign reserves and it is worth considering how to spend them ..... The money could finance more effective measures to underpin the international financial system.”

Japanese thought leader Akio Mikuni, president of credit ratings agency Mikuni & Company, goes even further. Reflecting on the currency implications of the present turmoil in a recent Bloomberg account, Mikuni noted “the dollar may lose as much as 40 percent of its value ... from the current spot rate (against the yen) ... unless Japan takes ‘drastic measures’ to help bail out the U.S. economy”. He went on to state “It’s difficult for the U.S. to borrow its way out of this problem .... Japan can help by extending debt cancellations.”

Whether or not Japan refinances its US treasury securities in this manner, many analysts believe the appointment of Timothy Geithner as US Treasury Secretary – a Japanese speaker who served at the US Embassy in Tokyo as Japan’s bubble economy was bursting – opens the door for greater financial cooperation.

It is also clear the Obama administration plans to spend substantial sums on infrastructure and green and renewable energy. This will promote job creation, allow for an upgrade of needed facilities and help to compensate for declining private sector demand. As the
effects of last year’s financial turmoil ripple through the real economy, it will take time for banks to recover from massive credit-market losses. Public works projects are likely to rise in importance as actions by the Federal Reserve and Treasury Department may not prove sufficient to stimulate demand as aging US baby-boomers and other households focus on paying down debt rather than the consumer spending that has driven growth in the past.

**The US also Faces Demographic Obstacles in Restoring Necessary Demand**

Japanese participation in US infrastructure, green/renewable energy and other projects is not simply helping an ally in need. Rather it is in its own interest. According to Ministry of Finance data released in December, Japan suffered a 26.7% drop in exports -- a decline that is likely to be aggravated as US baby boomers continue to age. As Merrill Lynch economist David Rosenberg states in a recent report titled “The Frugal Future”, “The median (US) boomer is moving into his 50s. After a buying boom over the past 20 years that has seen the level of non-housing durable goods assets on the consumer balance sheet almost triple to nearly $40,000 per household, it looks as though the boomers are done. For the first time in four decades, we cannot expect to see the demographic cushion to consumer spending that helped ease the blow in each of the recessions dating back to the 1970s.”

Plans by the Obama administration to create four million jobs over the next two years through public works spending can help to soften this transition -- and Japanese firms are already showing support for these initiatives. For example, last month then President-elect Barack Obama visited an Ohio plant, which manufactured components for wind turbines. The purpose was to highlight his dedication to reviving U.S. manufacturing and to create green jobs by investing in alternative energy. According to a Bloomberg account, Ohio Governor Ted Strickland was in attendance along with representatives from Mitsubishi Heavy Industries, the fourth-largest supplier of wind turbine machines in the US.

In addition to financing and other forms of support, Japanese firms possess substantial expertise in developing advanced and energy-efficient infrastructure. They also have the
potential to work with US engineers, infrastructure-oriented firms and labor and to help in efforts to promote clean energy and a more green economy. Mikuni appears to have something like this in mind when noting in the Bloomberg article references above “Japan should also invest in U.S. roads and bridges to support personal spending and secure demand for its goods as a global recession crimps trade.”

Assistance of this kind can also be seen as a means to reduce global economic imbalances through reduction of Japan’s foreign exchange reserves -- which approach $1 trillion. Furthermore, while an initiative of this kind has the potential to slow down yen appreciation – which rose 20%+ against the dollar in 2008 -- it is not likely to reverse it. As Mikuni noted “Japan will also have to accept that a stronger yen is good for the country in order to reduce excessive trade surpluses and deficits .... the model where the U.S. relies on overseas borrowing to fuel its property market is over. A strong yen will spur Japanese domestic spending and reduce import prices, thereby increasing purchasing power.”

A more robust domestic economy will create a more dynamic and attractive environment in Japan. This will increase competitiveness and efficiencies -- and foreign investment in this market. Given its many positive effects, the search for larger FDI inflows has been a long-term goal of the Japanese government. The success of firms such as Fedex, Chelsea Properties, Louis Vuitton, Tiffany’s, IBM and many others provide a model for other firms whose entry into the world’s second largest economy is now facilitated by these currency movements.

**The Primary Lesson of Japan is the Need to Recognize Change is Essential**

Many parallels can be drawn between current developments in the US and the collapse of Japan’s bubble economy in 1990. This includes issues relating to banking and credit, weakening demand, troubling demographics and a population that suddenly has less confidence about their future.
At the same time it would be a mistake to draw too directly a comparison. There are many real differences between the two countries. These include business practices, the composition of their populations, cultural and social attitudes -- and most importantly that Japan possessed the savings that allowed it to stretch out its transition while the US needs to adjust more quickly given its debtor status.

While the need to act quickly and aggressively is clearly important, the primary lesson the US can draw from Japan is that it would be mistake to believe current problems are a brief interlude that can be waited out until a recovery takes hold. While that may be true in respect to the banking sector once steps are taken to recapitalize troubled financial institutions, the structural shift in demand by aging baby boomers cited by David Rosenberg above -- from consumption to saving -- means in his words “The buy now/pay later days are clearly behind us.”

**US and Japan Need to Promote Growth and Demand in Asia and Emerging Markets**

As a result, global economic activity moving forward is likely to shift further from mature, over-saturated economies such as the US, Japan and Western Europe toward developing Asia and other emerging markets. While these economies have long recognized the need to develop their domestic markets and the consumer sector -- which is still in its infancy -- they have until now been largely content to remain reliant on exports to the US and other developed economies.

Given that increasing economic integration in Asia and other regional economies – is only likely to rise in importance -- US firms and policymakers would be wise to focus their attention more fully on these markets. That is true both to seeking corporate profits but also to help these economies grow in a sustainable manner. In terms of Asia, as Tobias Harris stated in a recent edition of the Nelson Report, “The allies need to develop plans for coping with China’s environmental, social, and economic problems, which for the foreseeable future will be of greater concern than the modernization of the Chinese military. Taking this path will require measures to minimize the gaps that separate the U.S. and Japan from China.”

Japanese companies also represent natural partners and are in an ideal position to work
with US firms to develop and expand their regional presence in China as well as other parts of Asia. Furthermore, given the leadership role Japanese firms are playing in growth industries such as green and renewable energy, robotics and other industrial applications -- there are a range of potential areas where US and Japanese firms can cooperate in their own markets as well as others around the world.

To examine the potential for East Asian Economic Integration and enhanced US-Japan relations under the new Obama administration, the Japan External Trade Organization (JETRO) and the Center for International and Strategic Studies (CSIS) will be organizing a conference on March 4, 2009 in Washington, DC. This program will feature prominent speakers and panelists from the US, Japan, China and ASEAN who will give a range of perspectives, which are designed to highlight the political, economic and commercial implication of these trends.

**Japan and the US Can Also Work Together on Important Multilateral Concerns**

In addition to a closer bilateral relationship and global cooperation between US and Japanese firms, in coming years there is certain to be movement to redefine the Bretton Woods and other multilateral systems and institutions that largely grew out of WWII, and which have come to define the way the world is managed today. The increased importance of Brazil, Russia, India, China and other emerging economies combined with the likely push for enhanced multilateralism under a new Obama administration are just a few of the many factors that point to the need for change. This will include the search for new solutions to better manage a rapidly evolving global financial system. Additional issues include trade, global security and terrorism, energy, global warming, the environment, health care and globalization. Japan and the US can work together to help develop workable solutions for these and other concerns.

Discussion of these and other pressing issues will take place in Washington, DC at the previously mentioned March 4 seminar JETRO is organizing with CSIS to analyze the increasing economic integration of Asia, the current state of the US-Japan bilateral relationship and other areas of potential cooperation. This meeting will be held without charge from 9:00 AM – 2:00 PM within CSIS’s Washington offices.
For additional information regarding the US-Japan bilateral relationship and the March 4th JETRO/CSIS seminar in Washington, DC, please contact Ryohei Yamada at JETRO New York at +1-212-997-0400, ext. 421 or rept@jetro.com.

Additional Resources:

Japan’s New Economic Growth Strategy

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