

PERSPECTIVES

JAPAN: RIPE FOR RE-ASSESSMENT

**DR MALCOLM COOK AND
HUW MCKAY**

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Japan: Ripe for re-assessment

**Malcolm Cook,
Program Director, Asia & the Pacific,
Lowy Institute for International Policy**

and

**Huw McKay,
Senior International Economist,
Westpac Banking Corporation**

The Japan of today is significantly different from the Japan of only a decade ago. Transformative changes are sweeping across its economy, political system and international policy. Yet, foreign perceptions have remained largely static and have focussed on the paralysing problems Japan faced in these three areas a decade ago. This static view means that Japan is often ignored as a swing factor in forward looking analyses. This report argues that these three transformations mean that a well defined “Japan view” is needed to sensibly analyse future regional and global trends. Japan is now more assertive, self-interested, controversial and confident. While the three transformations are incomplete and face serious internal and external challenges, each is well advanced, widespread and consistent. How these challenges are addressed and what that means for Japan’s role in Asia and beyond is what we should be focussing on. The view of Japanese passivity and genteel decline is clearly ripe for re-assessment.

Imagine the Japanese prime minister as the world’s second most powerful political leader. That sort of mental experiment generates hearty guffaws amongst the global diplomatic and financial community. The entrenched and often disparaging conventional wisdom about Japan makes laughter the ‘politically’ correct response. Yet Japan is the world’s largest creditor and second largest economy, boasts East Asia’s most powerful navy and the world’s third largest military budget.

Conventional wisdom, though, is often more about convenience than accuracy.¹ The entrenched view of Japan is of a fragile economy held down by a moribund financial sector; a paralysed, leaderless political system run by unaccountable shadow shoguns; and a meek

international policy characterised by chequebook diplomacy. Japan clearly has heft, but it lacks the will to throw itself about.

The national confidence level is rising. The economy is extremely close to turning the corner, if it has not done so already. In the last quarter of calendar year 2005, Japanese GDP growth tipped the scales at a 5.5% annualised pace. Prime Minister Koizumi is the most powerful politician Japan has seen in decades. He has significantly strengthened his grip on his party and state power. Economic reflation makes Japan more able to act as a global power while political reforms make it more willing. The country's international policy has responded by taking on a more assertive tone, focussing more intently on the pursuit of the national interest.

These changes are not simply anomalies. They are manifestations of long-running transformations in the economy, the political system and international policy. All three axes of change were borne out of crises in the early 1990s that exposed a dysfunctional system in an advanced state of decline. However, Japan has realised that business as usual was no longer good business, and is doing something about it. This *Perspectives* piece will look at the transformation of the economy, domestic politics and international policy. We will survey underlying structural changes, the tone of recent events, and the risks attending to each of the areas under discussion.

These changes are particularly important for Australia. Japan is Australia's largest export market and closest diplomatic partner in East Asia. Japan's economic transformation promises to reshape both global and regional finance and perhaps pressure the funding of Australia's persistent current account deficits. The trends in Japanese politics and international policy promise a more active and assertive friend for Australia to work with, but one whose strategic interests, particularly over China, may diverge from Australia's. This could present a serious challenge for Australia's interest in simultaneously seeking closer and more comprehensive relations with Japan, China and the United States.

Recovery and reflation

The Japanese economy is in the midst of its longest uninterrupted expansion since the second half of the 1960s.² Real gross domestic product (GDP) has averaged 2.0% annual growth since the middle of 2002. That is almost twice the rate achieved over the previous twelve years or so of stuttering growth and periodic recession. Japan's economic transformation has

been the sharpest of the three under study and the one that has gained the most attention. It is also the key determinant of national confidence.

Strong growth has accommodated a significant improvement in corporate and bank balance sheets, the labour market and the asset price environment. It is highly likely that the consistent consumer price *deflation* of recent memory will turn to moderate *inflation* in 2006. This fulfils the major pre-condition for a normalisation of Japan's unconventional monetary policy.

Normalisation, and all that assumes regarding economic fundamentals and asset markets, should have a profound impact on the investment choices of the Japanese. Domestic returns on investment should improve, making them more attractive. Japan is the world's largest exporter of capital and has been for some time. Even minor changes in the preferred investment vehicles of Japanese households can have major repercussions in global financial markets.

The major stress point reflecting these changes is the dollar-yen rate. The positive developments already observed, and those that can be reasonably expected, argue for a substantial appreciation of the yen. This, in turn, feeds into the assumption of a more assertive Japanese diplomacy.

Crisis

The Japanese economy grew at an average real rate of 1.1% in the period from 1990 to 2005, suffering three deep recessions along the way. Nominal gross domestic product (GDP) expanded at a 0.4% pace in that period, indicating that the absolute price level fell consistently. Along the way, official estimates of non-performing loans in the banking system grew to around 10% of GDP. Private sector analysts felt the level was much higher. The unemployment rate almost tripled, and the fiscal position deteriorated in spectacular fashion. Commercial land prices declined by a factor of 7.5 and residential land prices more than halved. The capitalisation of the Nikkei 225 stock market index declined by a factor of four.

The most damaging phenomenon in this catalogue of woes was the collapse of asset prices. The unprecedented scale of the shock to non-financial corporate sector and financial system balance sheets that this entailed, in tandem with the inherent rigidity of Japan's socio-economic institutions, condemned the economy to a painful and prolonged austerity phase. This period of private sector belt-tightening lasted for more than a decade, from the peak of

the bubble (early 1991) to the trough immediately preceding the current expansion (early 2002).

Chart 1: Japan's national balance sheet

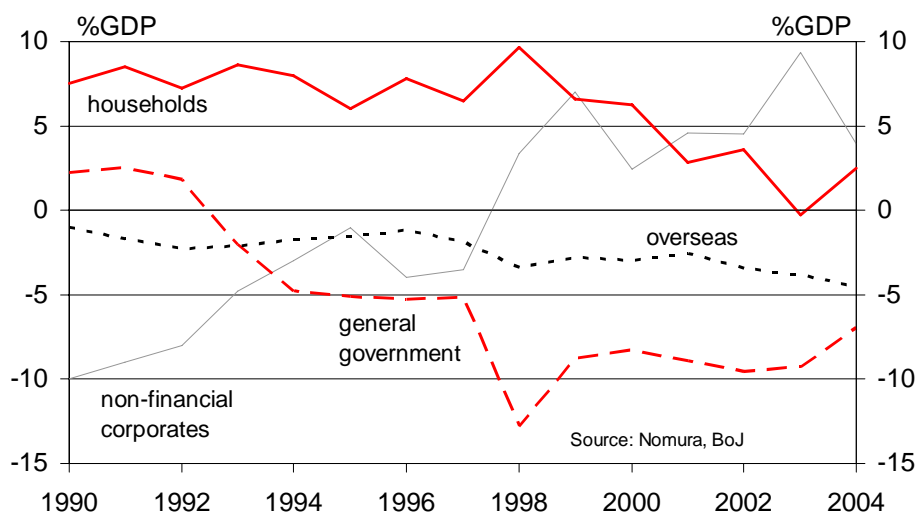


Chart 1's flow of funds framework clearly illustrates the economy's years of purgatory. In 1990, at the peak of the bubble, non-financial corporations were borrowing 10% of GDP from a combination of household and public sector savings. With asset price deflation disembowelling balance sheets from this point forward, companies were forced to move into debt retirement mode. They became net lenders by the time of the Asian Crisis, affecting a 15% of GDP swing in their borrowing proclivity over an eight-year period.³

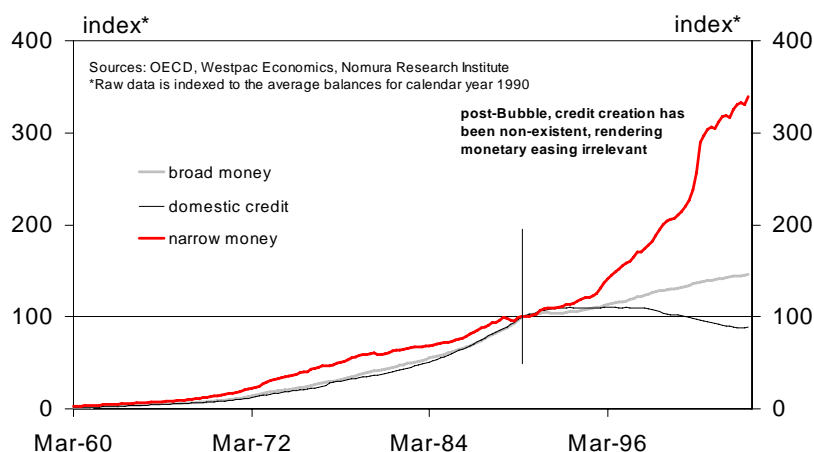
As households maintained a net saving position around 7.5% of GDP over this period, the economy endured serious savings leakages unmatched by borrowing. Without the government's willingness to plunge into deficit to the tune of 12% of GDP, it is clear that activity and the money supply would have contracted substantially. As it was the government did just enough for the economy to tread water while balance sheets recovered.

Under these extreme circumstances it was unavoidable that monetary policy would lose much of its potency. With companies unwilling to borrow regardless of price, the Bank of Japan was powerless to successfully pursue stimulatory policy. Even when nominal interest rates hit the zero bound (the "zero interest rate policy", ZIRP), and the central bank balance sheet was expanded by an additional ¥32 trillion yen ("the quantitative easing policy" QE), the corporate sector stuck to its contractionary debt retirement strategy.

Bank balance sheets were being attacked from two angles. Most obviously, corporate balance sheet deterioration increased the level of the banks' non-performing assets. Further, banks were hit directly by the deflating value of their cross-shareholdings, property assets and loan collateral. So not only were non-financial corporations unwilling to borrow, the financial sector was unwilling to add risk. The level of domestic credit is still lower today than it was fifteen years ago. Bank lending levels have declined annually since the middle of the 1990s.

From a monetary perspective this meant that the credit creation process broke down completely. Bank credit creation is the key to the monetary policy transmission mechanism. All other things being equal, for a certain level of base money, under 'normal' balance sheet circumstances for both financial and non-financial sectors, credit creation ensures that the level of broad money will be greater. If the benign balance sheet assumption is overturned, then the central bank can inject as much liquidity as they like (boosting base money), but broad money will remain unresponsive. That is precisely what has happened in Japan, as illustrated in chart 2.

Chart 2: Monetary policy has been rendered impotent



Signs of recovery and reflation

To confidently proclaim an end to this era, three basic trends must be observable. First, the debt of the non-financial corporate sector must have settled to a level consistent with a shift in management priorities away from debt retirement to more expansive activities. Second, the

asset price deflation that was such a major drag on balance sheets must have ended and asset prices must have begun to recover. Third, banks must have recovered sufficiently to again consider adding risk to their portfolios.

Chart 3: Bank debt* well below pre-Bubble trend

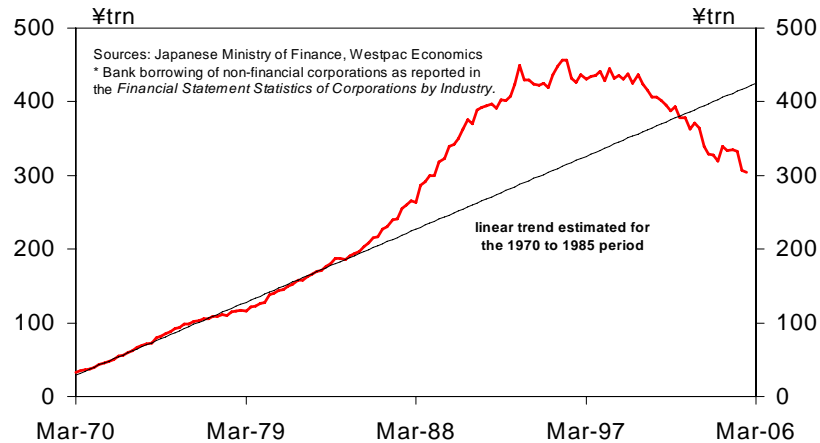
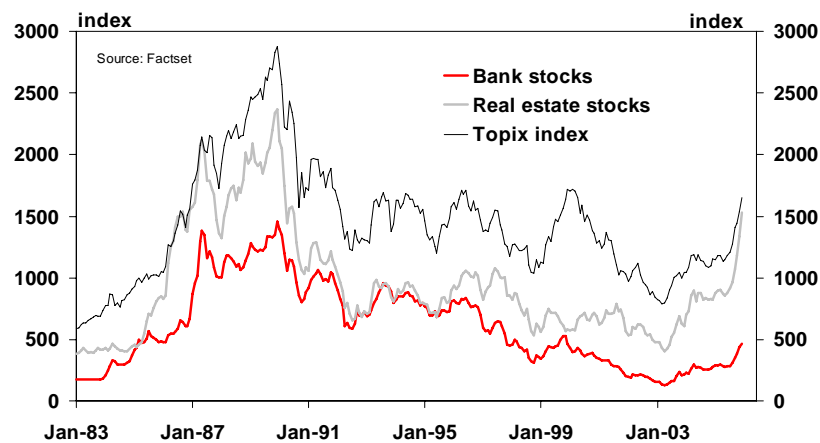


Chart 3 illustrates the first point through a time series of bank borrowings to non-financial firms. The benchmark level of debt “consistent with a shift in management priorities away from debt retirement to more expansive activities” is the linear trend line estimated using pre-bubble data. Debt levels have clearly fallen below this.

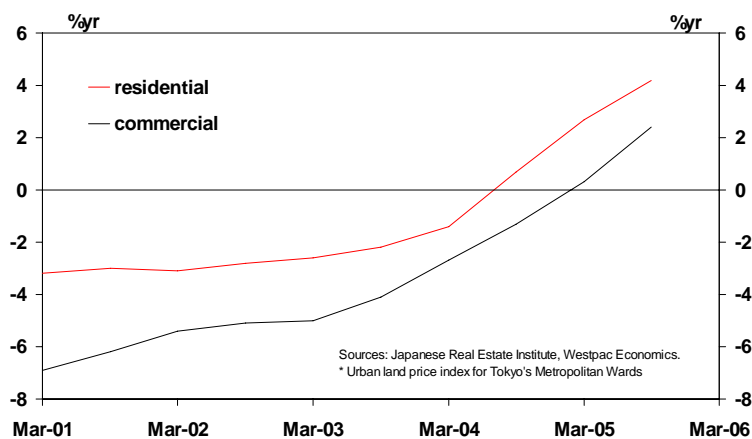
Chart 4: Japanese equity prices by sector



In terms of asset prices, the equity market has rallied strongly over the past two years (chart 4). Three reasons for this improved performance should be mentioned. First, strong domestic and global economic growth has provided a helpful backdrop for corporate cash flow. Second, foreign investors, sensing recovery, are returning to the market after a period when global fund managers were significantly under-weight in Japanese stocks. Third is the reduction in selling pressure from the financial reform requirement that banks unwind their pervasive cross-shareholdings. This process is now basically complete.

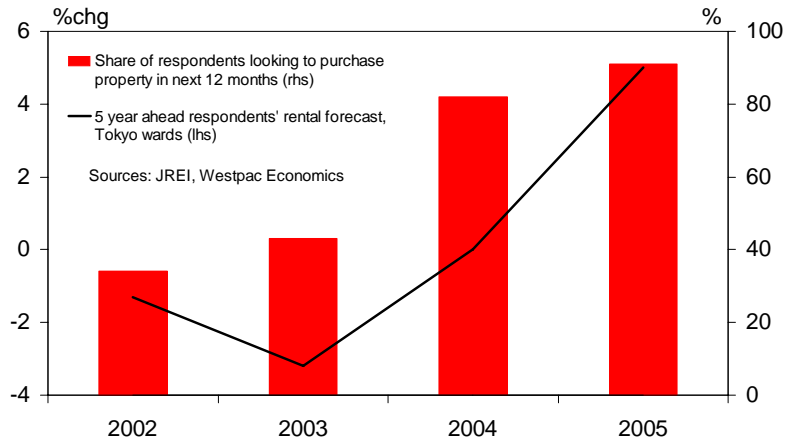
A recent survey of international fund managers indicated that Japanese equity prices were expected to again provide strong returns in 2006, after a 41% return in 2005. This more than doubled the return provided by the Australian bourse last year. Major investment houses are recommending an overweight position in Japanese stocks.⁴

Chart 5: Tokyo land prices* are no longer falling



On the real estate side, things are moving more slowly, but the indications are again positive.⁵ Commercial and residential land prices in Tokyo's metropolitan wards are no longer falling (chart 5). There are cranes on the Tokyo skyline. Major new office blocks have been erected recently, such as the impressive Roppongi Hills Mori Tower. Quality locations such as the area opposite the Imperial Hotel just off Ginza are being developed under scrap and build arrangements. Condominium projects in the central Tokyo area are proving popular with the capital's professional class.

Chart 6: Major shift in real estate investor sentiment

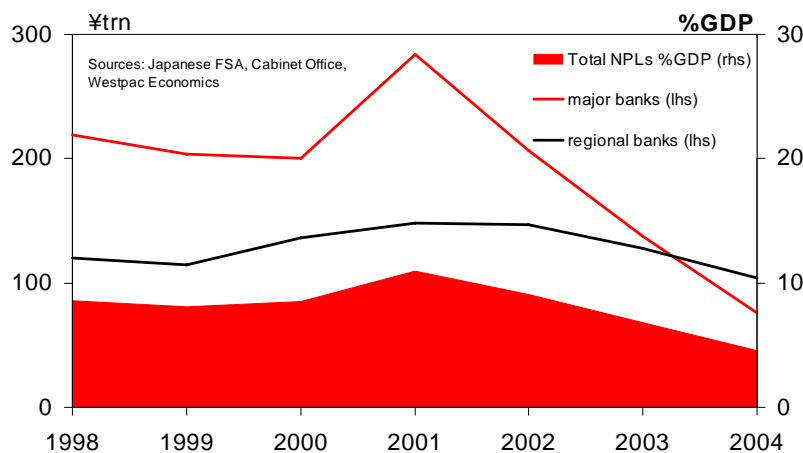


A survey conducted by the Japanese Real Estate Institute in November 2005 forecast a 5% rise in Tokyo rents over the next five years. Two years ago the same survey forecast a 3% decline in rents over five years. More than 90% of the professional investors responding to the 2005 survey were looking to acquire property in the next twelve months. Two years ago just 40% were looking to do so (chart 6).

It is true that outside of the major cities land prices are still falling, leaving nationwide measures still very much in the red. However, property markets usually slow from the outside in and inflate from the inside out. It should not be a surprise that the initial stirrings are in downturn Tokyo. What is important for the moment is that things are stirring.

On the financial system, the major banks (the city banks, trust banks and long-term credit banks) have been aggressively reducing non-performing loans (NPLs) through the current expansion. The major banks have reduced reported NPLs by around two-thirds since 2001, assisting a halving in the overall NPL/GDP ratio. Regional banks have been less successful at reducing NPLs, but they are starting to show some moderate improvement that should continue if economic growth remains supportive, and asset price reflation spreads to all corners of the archipelago (chart 7).

Chart 7: The non-performing loan pool has shrunk



As has been the case elsewhere in Asia, foreign investors’ strong risk appetite in this period of robust growth and accommodative global monetary policy has made this process somewhat easier than was the case in the years either side of the turn of the century.

These developments in asset price markets are positive for bank balance sheets. While banks no longer hold large tranches of corporate equities, they are massive property holders.⁶ Taken together build a picture of the development of bank-centred Japanese corporate groups, and the recent unwinding of cross-shareholdings.

Improving corporate sentiment reported across a range of surveys⁷, presumably reflecting balance sheet relief, will help banks in many ways. The most direct is in heightened demand for loan funds as firms move into expansion mode after a decade or more of debt retirement.

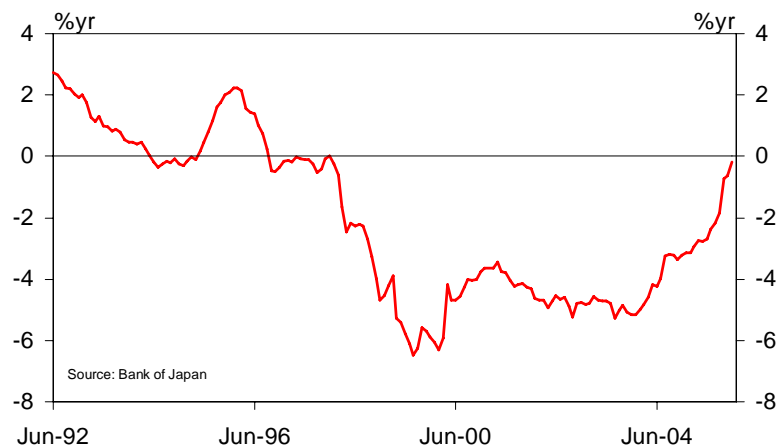
The Bank of Japan’s closely watched *Tankan* survey of business confidence offers more signs of recovery. The financial position net balance (“easy” responses minus “tight”) for all enterprises has recovered substantially from its most recent trough of –21 in 1998 to +6 in the December quarter of 2005. The current reading is well above the peaks reached in the 1990s. The last reading of the same magnitude occurred in the heady days of the bubble economy.

The net balance on lending attitudes (“accommodative” minus “restrictive”) is similarly buoyant. The all enterprise measure has recovered from –21 in 1998 to +15 in the fourth quarter of 2005. For the least creditworthy borrowers, small non-manufacturing firms, the equivalent numbers are –21 and +9. It is telling that in 1998 banks were so averse to risk that

they hardly distinguished between insolvent mom-and-pop borrowers and lean and mean global manufacturers.

The latest readings on lending attitudes seem to imply that the ice age in bank lending is thawing. Financiers appear willing and the corporate demand for funds is strengthening (chart 8).

Chart 8: System wide bank lending

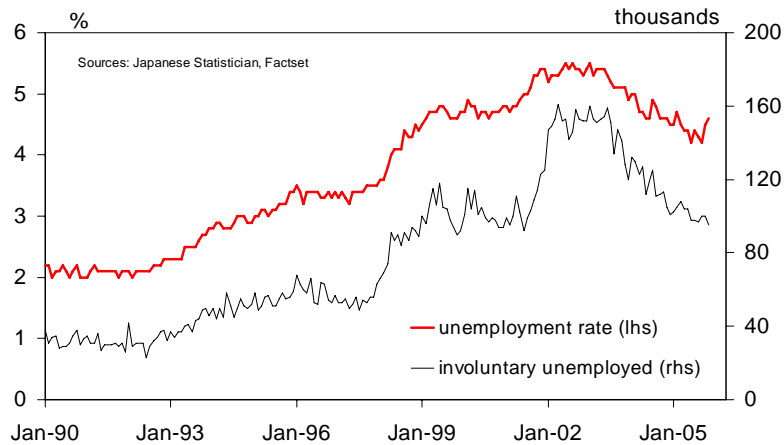


Back to work

The positive developments in balance sheets and asset prices have naturally spilled over into other areas of the economy. One of the most important trends in the real economy has been a steady improvement in labour market conditions.

Japan's unemployment rate rose steadily through the 1990s. The modest cyclical upturns observed during this period only managed to stabilise, rather than reverse, this trend (chart 9). The current expansion is different. The unemployment rate has been trending lower since the first half of 2002. Not only has the unemployment rate itself fallen by almost one percentage point, but the numbers of persons who want a job but cannot find one have been cut almost in half. The employment sub-index of the quarterly consumer confidence survey has recovered sharply since 2002.

Chart 9: The Japanese labour market



Japanese firms are about to receive a downward jolt to their aggregate wage bill. Millions of expensive older workers will retire in the next decade. They will be replaced by a smaller number of currently middle-aged workers. The new contracts these workers sign are unlikely to represent a major increase from current conditions, if recent history is any guide. They may even represent an outright decline.

The Tankan survey reports that the majority of firms have reduced the “excessive” components of their workforces to a neutral level, while in some sectors workforces are actually reported as “insufficient”. Hiring intentions for new graduates are strong. The jobs-to-applicants ratio is now at unity, having risen more than 80% from the cycle trough.

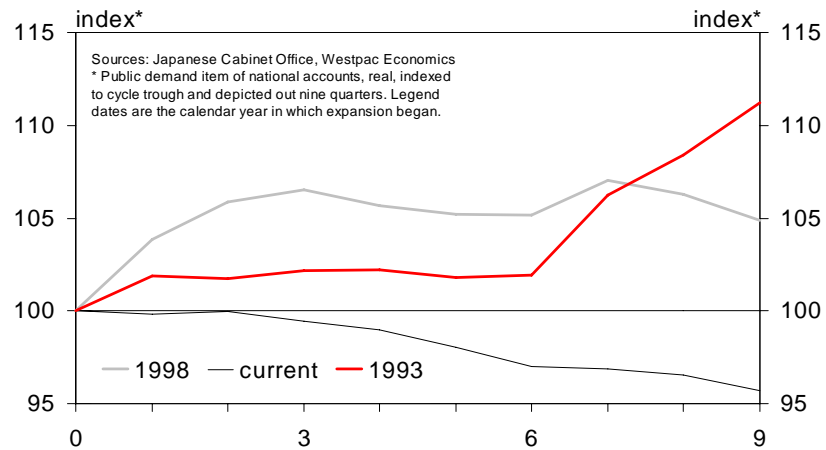
Steadier growth

Moves in the jobs-to-applicants ratio have a reasonable relationship with the growth rate of nominal wages. So it is clear that employers are not going to have it all their own way. A balanced recovery will require that household spending plays at least a supporting role, given private consumption comprises around three-fifths of GDP.

The present recovery is qualitatively different from the ‘false dawns’ of previous post-bubble expansions. This time around, public demand (government spending) has been a drag on growth. This contrasts markedly with the upswings beginning in 1993 and 1998, where fiscal stimulus made a major contribution to growth (chart 10). A reduction in the growth of public expenditures as part of the heavily publicised economy drive of the Koizumi administration,

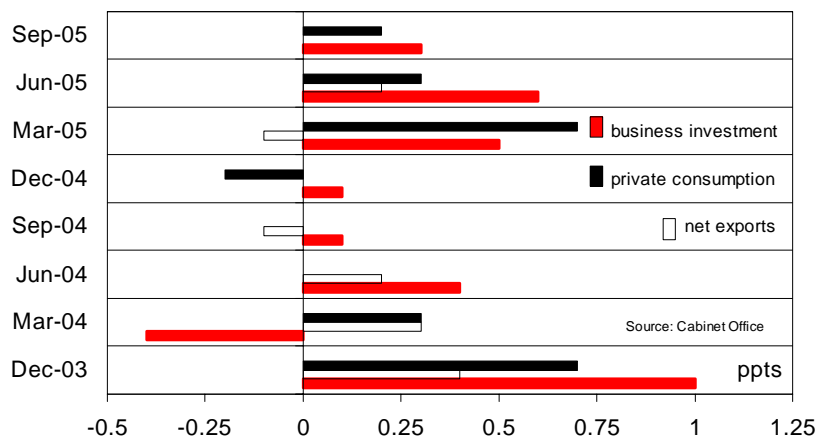
and an outright contraction in public investment spending, has been sufficient to stabilise the government's bond issuance program below ¥40 trillion.

Chart 10: The fiscal contribution to recovery cycles



The fact that private demand has been the major driving force of the current expansion means a great deal. Whilst net exports certainly played a part in the early stages of the upswing, their influence faded in calendar year 2005, when business investment and private consumption took the lead (chart 11). The private sector, not the government, is pump-priming the economy today.

Chart 11: Contributions to Japanese GDP growth



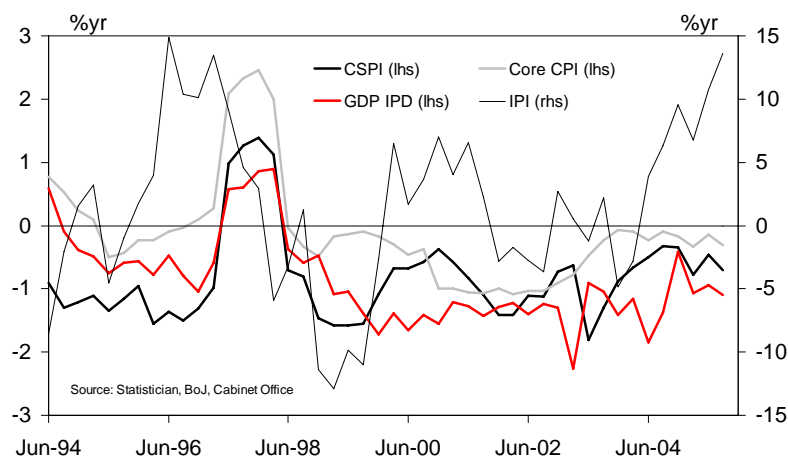
Monetary policy normalisation

This means that the Bank of Japan may begin unwinding its unconventional monetary policy in the year ahead. The normalisation of Japanese monetary policy is an important step in re-establishing the yen as an alternative international reserve currency. It is also a critical step in the recovery of Japan's financial diplomacy mojo.

The Bank of Japan's present monetary policy couples an overnight rate at or very close to 0% (ZIRP, the zero interest rate policy) and the provision of more than ample liquidity in the short-term money market via a current account balance target⁸ of between ¥30 and ¥35 trillion (QE, the quantitative easing policy).

The Bank is committed to maintaining this ultra-easy stance whilst deflation persists, as measured by the annual rate of change in the consumer price index. Under the published "exit conditions" not only must the consumer price index register a number of successive rises in annual growth terms, the Bank must feel that a future reversion to deflation is very unlikely. Recent price trends are illustrated in chart 12.

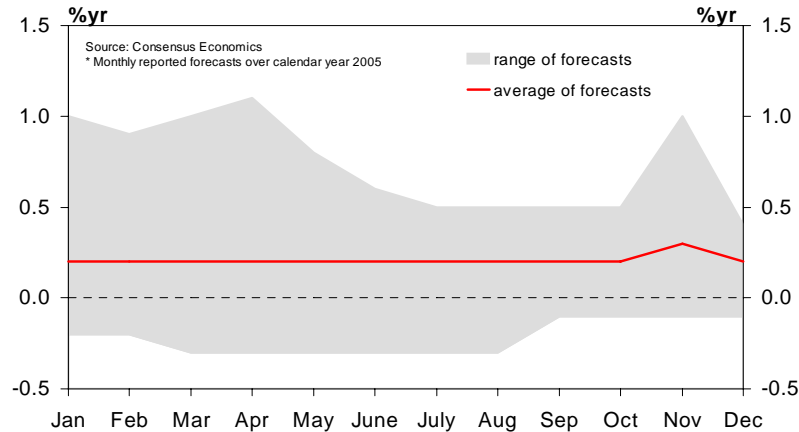
Chart 12: Japanese price measures



The Bank of Japan board have indicated that consumer prices will be positive in year-average terms in fiscal year 2006.⁹ Private sector forecasters appear to be of like mind. Whilst the range of forecasts in the *Consensus Economics* survey is much greater than those produced by the Bank's board, the mean expectation for 2006 consumer prices has been remarkably stable,

around +0.2% over the past twelve months (chart 13). On this evidence it is likely that the price condition for beginning to unwind quantitative easing will be met within the next year.

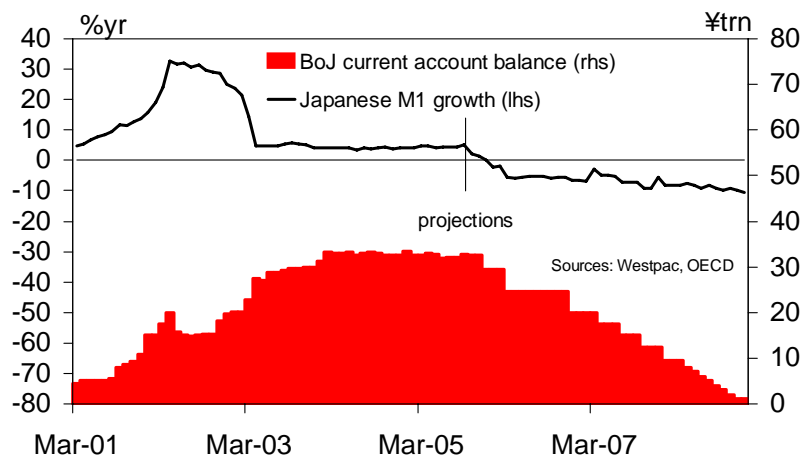
Chart 13: Consensus forecasts of 2006 consumer prices



That being the case, the logistics of normalising policy are of some interest. In the first instance the Bank of Japan will announce a new, lower target for current account balances. To achieve this lower target it must withdraw liquidity from the system. In other words the Bank must shrink its own balance sheet, and base money along with it. There are currently no central bank bills on issue, with the Bank in all out easing mode for many years. That creates a significant amount of flexibility in this direction.

Once the process has been started it will likely be carefully calibrated. It is difficult to envisage a 'cold bath' withdrawal of liquidity given the opposing views within government about the appropriate timetable for reducing monetary accommodation. A possible unwinding scenario is sketched in chart 14.

Chart 14: M1 growth with quantitative easing unwound



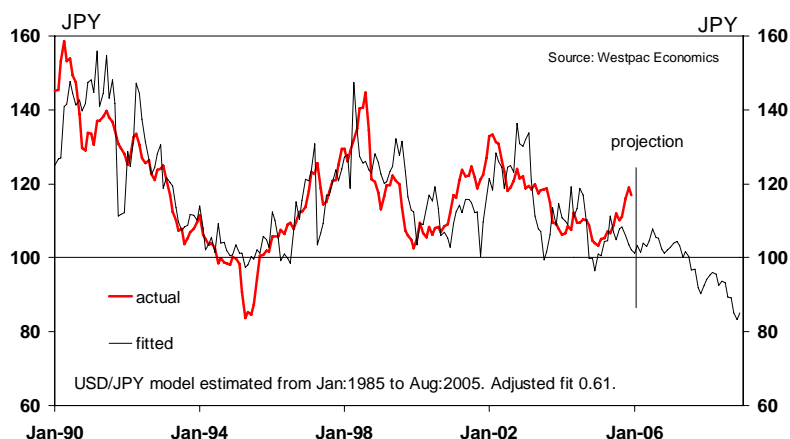
The excess liquidity sloshing about in the money markets reinforces the ZIRP. Once the Bank of Japan's current account balance is returned to a level that is neutral for the money demand/supply balance (say ¥5 or ¥6 trillion), the Bank can begin to countenance the possibility of returning to positive nominal interest rates.

A stronger yen

The normalisation of monetary policy promises to have major implications for the exchange rate. Fundamentally, the combination of the ZIRP and QE add up to a weak currency. Every major economy has an interest rate differential advantage over Japan. Further, the Bank of Japan has been printing money to maintain extreme liquidity in the money market. Thus the supply of the yen has also been extreme, as measured by relative growth in Japan's monetary base.

Using relative base money growth for the United States and Japan as a guide, the dollar-yen rate could move as much as ¥30 in Japan's favour from the beginning to the end of the QE wind down. The dollar-yen rate averaged just under ¥113 in 2005. That would imply that the all-time record low of ¥79 may be challenged within the next few years (chart 15).

Chart 15: Normalising policy means a stronger yen

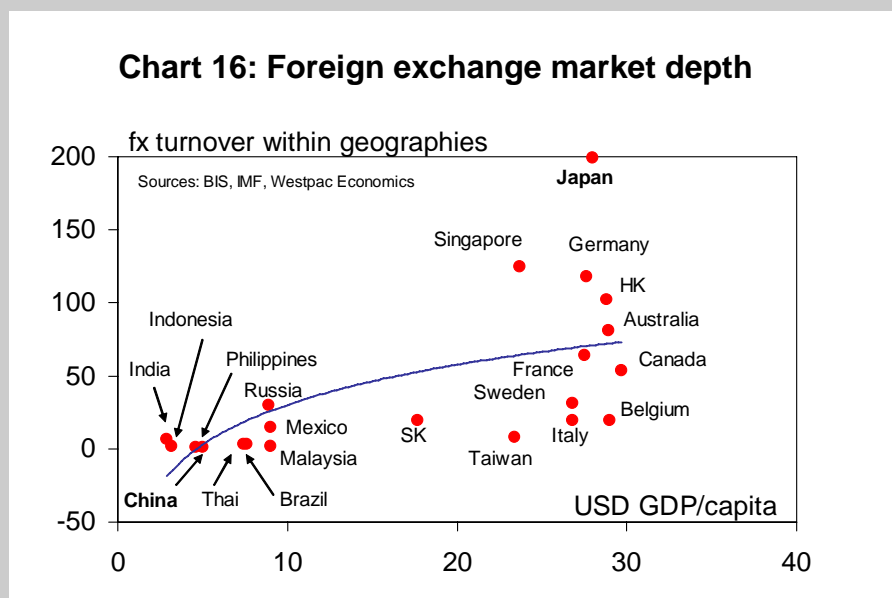


Other than a spectacular money supply shock, there are good reasons to be positive on the yen's trajectory in coming years. The trend of asset price reflation provides a compelling reason for Japanese households to invest more of their savings in domestic equity and real estate assets. At present the bulk of household savings end up in cash deposits (with the banks then purchasing Japanese government bonds), domestic and foreign bonds. In 2005, massive outflows into foreign bond markets took place, with billions of dollars of *uridashi* bond issues marketed to Japanese retail investors.¹⁰

The Japanese appetite for overseas investments should diminish once domestic assets offer better returns. While the high yields on foreign bonds have appeared very attractive in an environment of deflating domestic asset markets, why expose oneself to foreign currency risk when equivalent underlying returns may be available at home? Japanese investors were burnt by valuation losses on foreign investments in the last major yen appreciation cycle. Recycling a smaller portion of the current account surplus by investing more at home will further strengthen the yen.

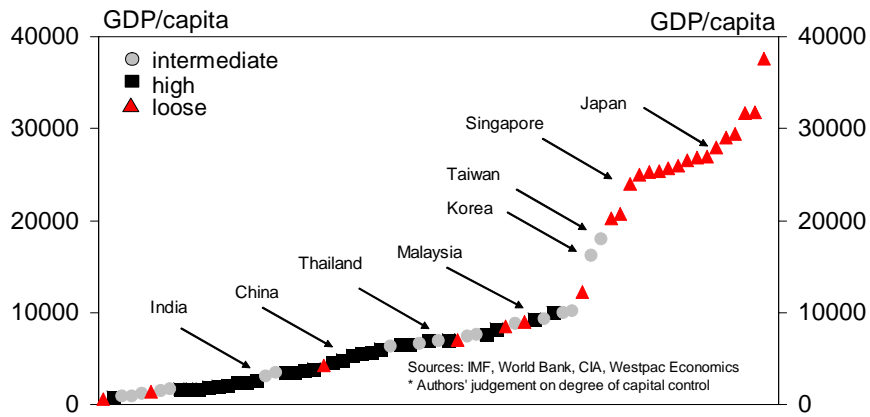
Asian financial hegemon

A stronger Japanese economy and the consequent normalisation of Japanese monetary policy will re-invigorate the yen as the bellwether of Asian currency markets. Many analysts have predicted that the Chinese renminbi will usurp this role sooner rather than later. We reject this hypothesis, at least for the next decade. The under-developed nature of China's financial markets, with foreign exchange turnover of less than \$US3bn per day in 2004, against around \$US200bn in Japan, essentially precludes it (chart 16).



Not only are China's financial markets illiquid and immature, the current constellation of exchange controls disallows most forms of capital outflow. While Japanese household savers directly impact upon global financial markets as their asset preferences change, Chinese investors are hamstrung from making like decisions. Japan runs a current account surplus and a corresponding deficit on the capital (plus financial) account. China runs surpluses on both the current and capital account, because regulations prohibit the recycling of inflows. The immense gap between Japan and China in this regard should not be understated (chart 17).

Chart 17: Capital freedom* & level of development



If correlations between regional currency movements are taken into account, it is clear that the yen is a much more important yardstick than the renminbi. The data in table 1 illustrates that the volatility of East Asian exchange rates is closely aligned to movements in the yen on a day-to-day basis. Relative to China it is not even a contest.¹¹

Table 1: Correlations between Asian exchange rates

	JPY	SGD	THB	TWD	KRW	CNY	PHP	IDR	HKD	MYR	INR
JPY	1.00	0.75	0.63	0.41	0.46	0.27	0.26	0.16	0.31	-0.04	0.33
SGD	0.75	1.00	0.69	0.53	0.55	0.45	0.25	0.25	0.34	-0.05	0.36
THB	0.63	0.69	1.00	0.52	0.56	0.46	0.37	0.23	0.31	0.06	0.32
TWD	0.41	0.53	0.51	1.00	0.62	0.31	0.31	0.24	0.28	0.05	0.42
KRW	0.46	0.55	0.56	0.62	1.00	0.36	0.32	0.20	0.30	-0.03	0.38
CNY	0.27	0.45	0.46	0.31	0.36	1.00	0.02	0.05	0.33	0.00	0.25
PHP	0.26	0.25	0.37	0.31	0.32	0.02	1.00	0.15	0.08	0.10	0.09
IDR	0.16	0.25	0.23	0.24	0.20	0.05	0.15	1.00	0.00	0.03	0.09
HKD	0.31	0.34	0.31	0.28	0.30	0.33	0.08	0.00	1.00	-0.05	0.26
MYR	-0.04	-0.05	0.06	0.05	-0.03	0.00	0.10	0.03	-0.05	1.00	-0.08
INR	0.33	0.36	0.31	0.42	0.37	0.25	0.09	0.09	0.26	-0.08	1.00

Sources: Bloomberg, Westpac Asian FX Guide. Correlation co-efficients of daily log changes in calendar year 2005. Where an effective onshore market is not present, offshore non-deliverable forward market data is used.

Japan's rise over the last century or so to the position of the world's second largest economy and the largest exporter of savings globally has given it an immense first mover advantage over China in the race to become the Asian region's financial hegemon. After a fifteen year hiatus, Japan may just be getting back to running a dynamic economy to match that financial might. And as discussed below, a more assertive Japan from a political and diplomatic perspective is clearly emerging.

Risks

The vision of the coming half-decade outlined above is not without downside risks. The most notable of these is the problem of coordinating policy across the Bank of Japan, the Ministry of Finance and the ruling party (or coalition). Japan's economic recovery will again face serious political barriers, requiring a serious dose of political fortitude to stay the course.

Monetary normalisation and an appreciating yen will put new pressure on Japan's compromised fiscal position. Gross government debt rose from 60% of GDP in 1990 to 140% of GDP when Koizumi became prime minister. For the majority of the Koizumi administration, central government expenditures have been roughly double its revenues. The only reason that this immense and growing debt stock has been sustainable is that the cost of servicing it has remained stable since the early 1990s. Deflation and absolute risk adversity across consumers, business and banks brought about a collapse in bond yields. Hence, while the level of bonds outstanding grows exponentially, interest servicing payments have not increased at all.

This is not sustainable. If the economy recovers, the price level resumes rising, short-term interest rates rise, and risk appetite increases, long bond yields will surely also rise, potentially quite sharply. The degree to which they will increase will depend upon the growth of new supply, and the veracity of the other trends identified in this paper.

Relying on bond yields remaining incredibly low is not going to be an effective strategy. Cutting back on the supply of bonds can mitigate the rise in yields, and a stronger economy will increase revenue opportunities. But Japan's stark demographic outlook caps potential growth in the 1¼% to 2% range, implying that Japan cannot grow out of its fiscal problems. Expenditure must be crimped, and new revenue sources tapped. A rise in the consumption tax is the obvious move. But given the violent electoral reaction to Prime Minister Hashimoto's attempt to hike the rate in the late 1990s, this is not an avenue that a weak leader will choose to pursue. Fortunately, Japan's political leaders are growing stronger.

Political leadership

The Japanese political system has been the most dysfunctional of the three areas under reform. Despite boasting one of the world's most electorally successful political parties, the Liberal Democratic Party (the LDP), the political system engendered neither the political will nor means to tackle Japan's mounting problems. Japan's revolving door of internationally faceless prime ministers seemingly hamstrung by party infighting and bureaucratic hegemony was the public face of Japan's decline. A stumbling economic giant absent political leadership. Yet, at the same time that the Japanese economy is regaining its feet, the country's political system is permitting, even promoting, strong political leaders able to represent the nation on the global stage.

Maverick Junichiro Koizumi's election as LDP president in 2001 (thus becoming prime minister) caught the attention of the world and the Japanese population because he promised to smash the old system from within. He rose to power in the LDP due to his public popularity based on his fresh persona and on his declared mission to reform the LDP and rid it of "the forces of resistance" to reform. Koizumi promised to lead.

Koizumi, now in his second and final term as party president, has delivered on this pledge and has set a new course for the Japanese political system and its dominant party. Maintaining this new course after its trailblazer steps down in September 2006 is necessary to consolidate Japan's economic recovery and to manage its new, more assertive international policy. A greater, more controversial international role demands a strong political leader.

Koizumi's personal charisma and news-worthiness have overshadowed the structural changes to the Japanese political system that helped create him. The LDP chose Koizumi out of newfound electoral frailty fully aware of his iconoclastic designs for the party. Koizumi has fought his own party more than the opposition. His electoral appeal has guaranteed his political supremacy and shielded him from the long knives aimed at his back.

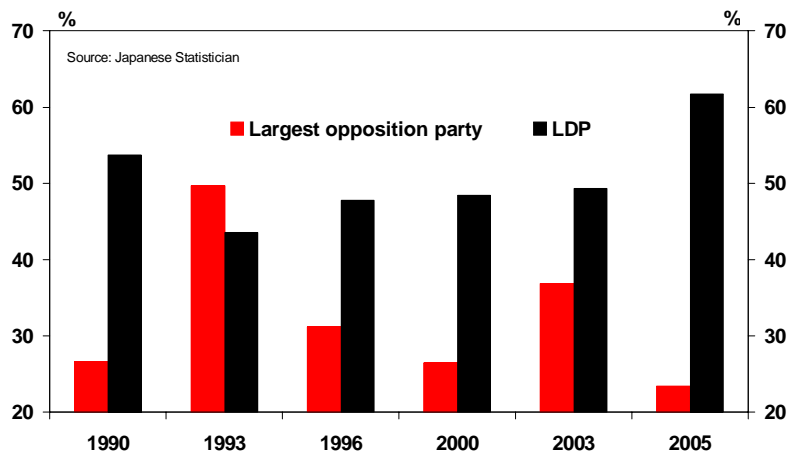
These changes strongly suggest that Koizumi will not be a flash in the pan. He has been the politician best able to benefit from these changes and to help entrench and expand them. Others are learning from his success while his newly empowered position in the LDP gives him an unprecedented chance to select his successor. The leading opposition party, after their latest electoral mauling by Koizumi, chose a young, right-leaning, outspoken reformist to

counteract Koizumi through imitation. As with Koizumi, Seiji Maehara was chosen more for his popular appeal than his factional pedigree and position.

Two elections twelve years apart show how much the Japanese political system has changed and the new opportunities it offers individual leaders and the traditionally ignored urban majority. On August 9, 1993, the impossible happened. The LDP lost a parliamentary election for the first time. Its 38-year reign at the top was over. This shock result and the coming to power of an seven-party, anti-LDP coalition sparked the series of structural changes to Japan’s political system that are still playing out today.

On September 11, 2005, the LDP’s resounding win under Koizumi, while facing the real prospect of losing power to the Democratic Party, reaffirmed Koizumi’s grip on power. It enhanced his ability to shape Japan’s political system going forward. The LDP under Koizumi has transformed itself against fierce internal opposition to remain competitive.

Chart 18: Distribution of lower house seats



These two elections may be viewed as bookends to post-occupation Japan’s most important period of political reform. In the twelve years between these elections, three waves of reform have taken place. In 1993-1994, the seven-party coalition used its nine-month tenure in office to reconfigure the Japanese electoral system in favour of small, poorer parties like themselves and the urban majority, their core constituency. From 1996 to 2001, the LDP and the prime minister strengthened political control over the policy process and Japan’s traditionally autonomous bureaucracy. Since 2001, Koizumi and his increasingly large group of younger supporters in the LDP have been centralising control within Japan’s dominant party and

making the party more appealing to Japan's increasingly important and independent urban electorate.

Crisis

The LDP lost the election in 1993 much more than the hastily cobbled together seven-party coalition led by LDP dissidents won it. People voted against the LDP and the past it represented, more than they voted for the promise of an untested coalition of mostly new parties that included the Japanese Communist Party. Japan's unfamiliar and confidence-rattling economic woes intensified public dissatisfaction with the prevailing political order and the stranglehold of the LDP's unaccountable "shadow shoguns" (faction leaders). A series of large corruption scandals involving senior politicians and bureaucrats, the defection of many of the LDP's young hopefuls and Japan's disastrous Gulf War diplomacy all deepened public anger with the political status quo and increased their willingness to throw the rascals (the LDP) out.

The ripples from the 1993 loss are still being felt today despite the seven-party coalition's premature collapse. It proved that the LDP could be beaten. Hope of success has enlivened the opposition. Freed from the Social Democratic Party's leftist ideological moorings that had kept the opposition it led from ever posing as a serious alternative, they go to the polls feeling that they have a chance. Since 1993, the opposition has moved to the centre of Japanese politics and united itself as the Democratic Party of Japan. Many thought the Democratic Party would gain power in 2005 after winning the most seats ever by a single opposition party in the 2003 election. Today, there is no other credible opposition party or coalition of parties other than the Democratic Party. Japan finally has a competitive two-party system.

The 1993-1994 electoral reforms were the first building blocks of the emerging system. The first significant reform partially unwound the scandalously gerrymandered electoral system that gave rural votes three times more influence than urban votes. Now, each rural vote only counts for twice as much as an urban vote.¹² Combined with the decline and rapid aging of Japan's rural areas, today, Japan's long-suffering urban voters hold sway, presuming they make it to the ballot box.

The coalition also passed new laws that changed the electoral system and weakened the previously dominant voice of party factions. They shifted Japan from a multi-member district electoral system that favoured large parties and emboldened factions. In multi-member

districts, members from the same party run against each other, making access to factional support and finances frequently more important than loyalty to the party. The new electoral system featured 300 single-member districts (undercutting factional control) and 180 proportional representation seats allocated regionally (favouring smaller parties with national rather than geographically concentrated support). Party lists for the proportional seats are decided by the central party structures, giving them more hold over individual candidates. Moreover, the new laws encouraged electoral funds, including new public funds, to flow through central party structures rather than through factional channels.¹³

The 1993-1994 reforms strengthened the still under-represented urban vote and weakened the previously dominant role of party factions. It has also benefited the new Democratic Party with its more national, less geographically specific appeal. In 2003, the Democratic Party won more proportional representation seats than the LDP.

Executive control

The second wave of reforms was carried out by the chastened LDP upon their return to power in 1994. Backed by the growing number of corruption scandals involving Japan's powerful bureaucratic ministries, LDP administrations increased political control over the policy process and the prime minister's control over cabinet. The previously esteemed bureaucracy bore the brunt of the blame for Japan's economic woes both within Japan and overseas.¹⁴ This, ironically, helped LDP leaders wrest more control over the policy process.

The 1996-2001 reforms focussed on strengthening the resources and position of the chief cabinet secretary and Secretariat. The Secretariat is the executive's main policy formulation body while the secretary is the prime minister's main policy spokesperson. Under the old system, the secretary was not a cabinet-level position while the Secretariat as a whole had few resources and was manned by junior members of the main line agencies. The Secretariat's co-ordinating role was simply that. It co-ordinated the decisions made by the ministries.¹⁵

Today, the Cabinet Secretariat is much larger and more influential. It has had primary control over much of Japan's most important new legislation of late, including the post-September 11 counter-terrorism laws and new intellectual property laws. The chief cabinet secretary, usually a close political confidant of the prime minister, is now a cabinet-level position and first in line to take power if the prime minister dies or falls ill, as happened with Prime Minister Obuchi's death in 2000.¹⁶

Prime ministers have also bolstered their own power and the power of the Secretariat by appointing a larger number of policy advisors from outside the line agencies. These administrative changes present the prime minister with the tools for enhanced political leadership and the political will to push through reforms more quickly. Today, all senior bureaucratic appointments need to be approved by cabinet. The bureaucracy, with its inbuilt resistance to change, is on the back foot while cabinet and activist prime ministers are on the front foot. Japan's government is shifting from a mandarin-led regime to an executive-led regime.

LDP rebuilt

Since 2001, Koizumi has effectively used these structural changes as weapons in his fight to reshape the LDP into a modern, urban-focussed party – and to bolster his own popularity. Koizumi's main political fight has always been within his own party and most of his major legislative reform efforts have targeted this intra-party battle. Japan's long overdue fiscal retraction and the privatisation of the major highway companies and the gargantuan Japan Post (and its \$US4 trillion in assets) have weakened the rural-focussed pork barrel politics at the core of the factional system. Koizumi has married fiscal responsibility (necessity) with this intramural turf war to try to starve his opponents of funds.

Koizumi's first salvo was to appoint for the first time a cabinet not based on factional balance and seniority but on specialist knowledge and loyalty to him. Koizumi's first cabinet was the youngest in Japanese postwar history. In the run-up to the 2003 election, he then introduced a retirement age of 73 for LDP candidates, sidelining much of the LDP's old guard. This group included former prime minister Nakasone, who was first elected to parliament in 1947. Nakasone has unsurprisingly become one of Koizumi's harshest public critics.¹⁷

The 2005 election was the litmus test for how far Koizumi's reform of the LDP had gone, and the popularity of the moves. Koizumi called an early election after 37 LDP members helped defeat his postal privatisation bill, clearly linking the election and his leadership to his intramural turf war. A vote for Koizumi was a vote for his mission to entrench a new LDP. Koizumi used central party control over candidate selection and the proportional representation ballot to sideline many of the 37 dissidents and to promote many first-time, young "assassin" candidates in their place. Some of the most powerful faction leaders in the LDP like Mitsuo Horiuchi and Shizuka Kamei quit the party after voting against the postal privatisation bill.¹⁸

The LDP's landslide win reaffirmed Koizumi's mission. For the first time since 1990, the party won the majority of seats with 296 out of the 480 available. This was its second-highest seat tally ever. The LDP won 59 more seats while the Democratic Party, led by the uncharismatic Katsuyo Okada, lost 64 to fall to a lowly 113. That said, the Democratic Party maintained roughly the same percentage of the vote as they won in their breakthrough 2003 election. The LDP gained votes at the cost of smaller opposition parties, thereby strengthening the shift to a two-party system. The LDP sharply increased its vote among the growing number of young, urban swing voters and convinced many previously apathetic citizens to vote. Historically the LDP does better the lower the turnout. Koizumi has reversed this trend.

Many of the "forces of resistance" leaders have been flushed out of the LDP. The party's newfound strength in Japan's major urban areas will further weaken their power. Today, over one-half of the LDP members in parliament do not come from the traditional factions and the large majority of them are tied to Koizumi. The LDP, and the centralised opposition, are younger, headed by strong leaders and dependant on attracting the large urban swing vote. In many ways this is the exact opposite of the pre-1993 political picture.

Koizumi has elevated his closest and younger lieutenants such as Shinzo Abe and Heizo Takenaka to the top cabinet positions and has indicated he will personally support (anoint) a successor when he steps down in September. Koizumi has used the new, more competitive electoral system and strengthened central party mechanisms to gain unprecedented control over the LDP and to reshape it in his own and the electorate's image.

It is very likely that he will be able to anoint his successor – most likely 51 year-old chief cabinet secretary Shinzo Abe – and maintain a firm hand on the party after he steps down in September. Japan now has an executive-led government with younger, more forceful leaders able to control the policy process and to leverage their personal popularity.

Next in line

Shinzo Abe's elevation to chief cabinet secretary is the clearest indication that he will be Koizumi's choice as successor. Abe combines his mentor's assertive approach to politics and his desire to enhance Japan's international role – on its own terms – with a peerless political pedigree. His father was a former Minister of Foreign Affairs and his grandfather was a former prime minister (and accused war criminal). Abe, better than anybody, personifies both

the new political era (he first won office in the disastrous 1993 election) and the LDP's respect for tradition.

As with Koizumi and his grandfather, Abe sees strong relations with the United States as central for Japan. He knows the United States and the leading figures in the Bush administration well. Abe studied in San Diego and frequently visits Washington, where he counts Vice President Cheney as a close friend. In tone, Abe is more right-leaning than Koizumi, takes a tougher line on China and visits the Yasukuni shrine more freely. Abe is known as "Japan's neo-conservative."

Risks

The changes to the Japanese political system are real and the urban swing vote will continue to grow in importance. However, Koizumi's very effective use of the new political system may pose the greatest risk to his mission and its corollary, fiscal responsibility. Since 2003, Koizumi's mission has been more successful at re-establishing the LDP as the dominant party than at guaranteeing his successor's control over the party. The LDP and its coalition party Komeito now control over two thirds of the seats in the parliament and the Democratic Party has lost some of its earlier lustre. The party can now afford to again sacrifice some popularity to serve its own shrinking traditional constituencies, who are still very dependent on LDP-approved state largesse granted by their party barons.

Koizumi has been successful at building his base in the party but even today it is not clear that he and his supporters have the firm support of the majority of members. Koizumi will likely be able to put in place his chosen successor but will that successor be able to inherit Koizumi's supporters and build up his own base? This problem is exacerbated by the fact that the next series of economic reforms will carry a higher popular cost than post office privatisation. Tax and pension reform are next in line and have obvious potential to anger large swathes of the population, especially if they coincide with a cyclical downturn in the economy. Japan's voters are as averse to tax increases as voters elsewhere.

Australia's interests

A more assertive, executive-controlled political system dependent on the urban swing vote in Japan is a good thing for Australia. It means that political pronouncements from Tokyo can be taken more seriously and that Japanese prime ministers have a greater political interest in

being seen as effective global leaders. It would have been very difficult for the pre-1993 Japanese political system to have even countenanced sending forces to Iraq.

Certainly, the Japanese government, slowly, is more willing to join the global tide of pursuing bilateral FTAs as a supplement to the stalled multilateral process. The farm lobby and its powerful backers in the Ministry of Agriculture, Fisheries and Forestry and the LDP have not melted away or been sidelined. However, they will likely be a hurdle for Japanese trade diplomacy, not a brick wall. Japan signed a free trade deal with Mexico in 2004 that included agricultural concessions strongly opposed by the farm lobby.

A trade deal with Australia would touch on more sensitive issues – including rice – and so would be more difficult. But while a trade deal with Japan was a pipe dream not worth pursuing a decade ago, today it is more likely to be a very difficult and drawn-out affair, but with the moderate possibility of a satisfactory result. Australia has already benefited greatly from earlier rounds of agricultural liberalisation in Japan. Half of the beef consumed in Japan comes from Australia.

Harnessing power

International policy is where Japan's more assertive political tone is clearest and where the economic recovery may deliver the greatest returns. Japan's new politics makes its leaders more willing to use the country's undoubted power resources, while its economic recovery enhances these. Many though, particularly neighbouring countries in the North Asian crescent, are growing increasingly uncomfortable with this new Japan.

Japan's pursuit of national interest in the post-war period was very unconventional, as Japan essentially chose not to use its significant power resources. Japan was the superpower that wasn't. This is why it is so hard to see the Japanese prime minister in the same global light as the American president or even the British prime minister. Japan is slowly starting to act more like a great power in a region already bristling with them.

The four major pillars of Japan's traditional international policy – no involvement in foreign military operations and collective security, strong support for the United Nations, heavy reliance on development aid and a conciliatory approach to the People's Republic of China – are all under serious review in Tokyo. Japan is more willing to antagonise others, to push the envelope on the constitutional limits of its undeniable military capability and to calibrate more carefully foreign policy outlays with foreign policy outcomes. Japan's international

military involvement is growing while its official development aid budget is shrinking. Alliance relations with the United States are tightening while regional interests are becoming increasingly competitive.

Crisis

Despite being on the winning side in the first Gulf War (1990-1991) along with the other 31 members of that United Nations' endorsed coalition of the willing, Japan lost face. It was an disaster for Japanese international policy.

Japan initially refused to send any military support to the Gulf pleading, with reason, that the war-renouncing Article 9 of Japan's 1946 constitution barred Japan from participation. Japanese public opinion was also strongly against any involvement. Instead, Japan became a major creditor of the war effort, contributing roughly \$US13 billion funded by a very unpopular "Gulf War" consumption levy.

However, at the war's end, Kuwait publicly thanked all other members of the coalition that fought against Iraq but, pointedly, did not thank Japan.¹⁹ Throughout the campaign Japan was heavily criticised by the United States for not acting as a responsible power and failing to support the United Nations and its collective security mandate.

Japan's standing in the United Nations and its long-term policy goal of gaining a permanent seat on the Security Council suffered a serious blow. Japan's "peace constitution", which is a palliative to fears of Japan in East Asia, became a serious impediment to its dream of achieving a permanent seat on the UN Security Council and the global status that entails. \$US13 billion and constitutional limitations did little to stem the tide of global opinion against Japan. A substantial international policy outlay had delivered a substantial policy failure.

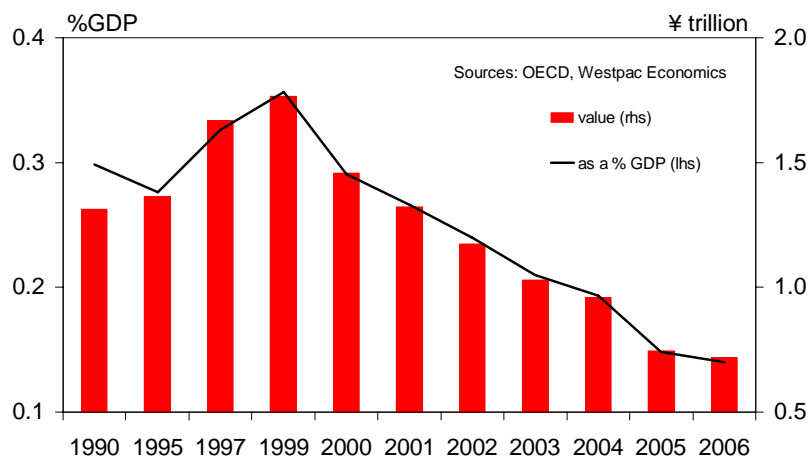
Cutting costs

Japan's economic and fiscal woes coincided with growing concerns within the government that Japan's huge official development aid outlays were not serving the national interest. Some of the largest recipients of Japanese aid, particularly China and Cambodia, did not support Japan's failed bid for a Security Council seat in 2005. That understandably led to anger in Japan and renewed internal criticism of its aid generosity. In response, in early 2006, the prime minister announced plans to set up a new cabinet-level panel to ensure that Japan's official development expenditures are closely aligned with Japan's international policy goals.

These goals include rebalancing Japan's relations with China and garnering support for Japan's pursuit of a permanent Security Council seat.

With Japan's newly empowered elected leaders tightening their control over the aid budget, it is being slashed. The aid budget has declined each year since 1999, with a further 3.4% cut announced for 2006. In dollar terms, Japan's aid budget, as reported by the OECD, has more than halved in the last seven years from \$US15.5 billion in 1999 down to \$US6.8 billion in 2005. While Japan is still the world's largest creditor economy, it is no longer the largest single source of foreign assistance. The chequebook is closing.

Chart 19: The foreign aid budget



Flexing muscle

The first Gulf War acted as a rude introduction to the post-Cold War era and the new challenges this poses for Japan. The United States now demands more from its alliance partners and more international attention is focussed on Japan's global role. On top of this, the rise of China, both economically and diplomatically, alongside North Korea's nuclear malevolence, have increased Japan's contiguous threat perceptions and complicated regional relations. Japan is now facing a more threatening, competitive security environment, a strong challenger for regional leadership, and a more demanding alliance partner.

The world is less tolerant of Japan's non-participation in collective security, while Japan's Northeast Asian neighbours remain vociferously opposed to Japanese international military involvement. Japan has to loosen the constraints of Article 9 if it wants to be regarded as a "responsible global power" and "good international citizen" by its OECD brethren. But any

move in this direction inflames raw historical nerves in Northeast Asia and fears of a return to militaristic nationalism.

This more challenging security environment has softened the Japanese people's pacifism that was forged in the embers of Japan's defeat in World War Two. That has provided Japan's political leaders more latitude on security matters. Japanese people's views of North Korea and China in particular have soured over the last five years. Japan's newly empowered political leaders are taking advantage of this expanded latitude and have adopted a more assertive tone on Japanese security. Both Koizumi and Maehara support discussing constitutional amendments, while foreign minister Aso publicly calls China a "considerable threat." International policy is providing the strongest bi-partisan platform for Japan's new politicians to exhibit their stronger, more confident personas.

This more assertive tone is being backed up by more assertive actions. In direct response to the failings of the first Gulf War, the parliament passed the peacekeeping operations bill in 1992. The act permitted overseas deployments of Japanese soldiers in non-military positions on United Nations sanctioned missions. Defence Agency Director Nukaga recently called for international peace-keeping to be defined as one of the main duties of Japan's Self Defence Forces. Japanese troops now routinely participate in global security efforts, including the use of military assets to help the tsunami recovery. At the same time these assets are growing as Japan recently launched its own spy satellites and is planning to purchase in-air refuelling capabilities for its air force. The government is also considering lifting Japan's ban on the exports of arms while plans are afoot to elevate the Japan Defence Agency (currently under the Prime Minister's Office) to a cabinet-level Ministry of Defence. These actions are certainly stretching Japan's decades-old, narrow definition of territorial self-defence.

Today, the USA-Japan alliance is an American led bilateral regional security mechanism and not a unilateral guarantee of Japan's territorial integrity and passivity. Japan is increasingly an *actor* in regional and global security rather than a *subject* of the same. In the first Gulf War, Japan declined to send any forces in spite of the United Nations' sanction. In the second Gulf War, Japan sent and re-deployed troops despite the lack of United Nations' sanction.

In 1996-1997, the United States and Japan redefined their alliance away from its traditional focus on the territorial defence of Japan towards a more active role in regional security. The Japanese government has also signed up to the American anti-ballistic missile defence program (as has Australia). Recently, the defence agency rewrote the details of the alliance to allow the Americans to base a nuclear-powered aircraft carrier in Japan, enhancing the Pacific

Command's force projection capabilities and undercutting the national nuclear taboo. For the first time ever, in 2005, the USA-Japan joint statement on the alliance directly mentioned Taiwan as a shared security concern.

China

Japan and China have never before been assertive global powers at the same time. The deterioration of Japan's relations with China over the last decade is the best example of Japan's new assertiveness and its dangers. Relations with China have been second only to relations with the United States for Japan. Until recently, Tokyo had taken a more conciliatory approach to China than the United States and many other countries in the Asia Pacific. Today, the Koizumi administration may have the hardest line towards China of any major country, leading Washington and others to caution Tokyo (and Beijing) to tone it down. Today, the leaders of Northeast Asia's two dominant powers cannot even agree to meet each other, with each side accusing the other of responsibility for the stalemate. While Southeast Asia was the centre of the "China threat" thesis in the early 1990s, today voices in Japan and the United States are its loudest proponents.

Aid flows between Japan and China track this rapid decline in relations. China has witnessed the sharpest and most politicised fall in aid inflows from Japan. From 1999 to 2003 alone, Japanese aid to China was cut in half in nominal terms from \$US1.85 billion to \$US925 million. Prior to 1999, China was the only recipient of Japanese aid outlays that did not come under annual review. Now aid to China is reviewed each and every budget cycle.

Japan's new more assertive security posture also has a particular China flavour. For the first time, in 2005, the United States-Japan joint declaration on the alliance mentioned Taiwan (the former Japanese colony of Formosa). That infuriated the Mainland. Japan's most recent defence white paper also mentions China as a security threat. While Japan's diplomatic relations with China are frozen in acrimony, Japan's unofficial relations with Taiwan are warming up, including the 2005 visit to Japan by leading Taiwan independence advocate, Lee Teng-hui. To the ire of China (not to mention Russia and South Korea) Japan is more actively seeking to advance sovereignty claims to its offshore islands, including disputed ones, and their energy and fishery resources.

Regional leadership

For the last decade, Sino-Japanese rivalry has played out in their competition to lead East Asia. Before China's meteoric economic and diplomatic rise, Japan was East Asia's only

viable leadership candidate. Japan's means were indirect (economic) rather than direct (politico-diplomatic). Nipponophile leaders like Malaysia's Mahathir accommodated this strategy. The Japanese Ministry of Finance established the Asian Development Bank in the 1960s and took the regional lead in responding to the Asian financial crisis in 1997-1998. Japan has been one of ASEAN's most active and cooperative dialogue partners and helped establish APEC.

The economic recovery and the unparalleled depth of its financial markets mean that leadership through financial means could easily revive Japan's regional leadership claims. Ministry of Finance officials saw the short-lived Asian Monetary Fund proposal in 1998 as a means to strengthen Japan's leadership and the yen's international standing. Japan actively sought to organise bilateral currency swap agreements with regional central banks as a prophylactic measure in the wake of the Asian currency crisis. China has been much more wary. Japan's regional financial weight can only benefit from Japan's internal economic recovery. Further, finance offers Japan's most striking competitive advantage in the battle with China for the hearts and minds of the region.

Risks

The ongoing diplomatic standoff between Tokyo and Beijing and South Korea's growing anger with Japan are testament to the risks associated with Japan's new assertive international policy and its domestic political dimensions. The standoff has already stalled any concrete progress towards regional integration and turned this into a competitive process rather than a cooperative one. Unfortunately, the standoff seems to be self-perpetuating.

As shown by China's public opposition of Japan's Security Council dream last year in the build-up to the United Nations Summit, Japan's assertive international policy risks making many of its long-held policy aims harder to achieve. The first Gulf War exposed how the traditional approach was a failure. It is far from clear that this new approach will do any better. If the Chinese (and Korean) view that Japan's more abrupt diplomatic style is due to the revival of imperialistic nationalism becomes widespread, then Japan's long-standing fears of isolation will grow. Under those circumstances the yen's rise to the status of omnipresent regional reserve currency would be scuppered.

The growing clash between Japan's new more assertive tone and good regional relations may spark increased domestic opposition. That would complicate or preclude core actions such as

constitutional revision. The Democratic Party under Okada tried to make Japan's deteriorating relations with China into an election issue in 2005. LDP leadership hopeful Yasuo Fukuda has consistently called for a more conciliatory approach to China. Okada lost the election and Fukuda was demoted in the last cabinet shuffle. Yet, Koizumi's opponents in the LDP may try to use the China card in the battle over his replacement, especially as many of these have long favoured close, commercially oriented relations with the Mainland. Relations with China are now the most charged international policy issue in Japan and will increasingly play a role in domestic political battles.

Australia's interests

Given our close relations with Japan, a more assertive tone in its international policy means a lot for Australia. On the positive side, it means that Japan has become an equally keen partner in closer security cooperation with Australia, with the number of high level and low-level military contacts growing rapidly over the last decade. The most important of these new developments is the USA-Japan-Australia security triologue that has recently been elevated to the ministerial level. The USA-Australia and USA-Japan alliances have always been closely wed and are getting closer. Japan's more assertive role in its alliance also supports American interests in the region and indirectly strengthens the Australian alliance.

Australia and Japan also share very similar interests in regional integration. Japan was the most prominent voice calling for Australia's inclusion in the recently established East Asia Summit. Like Australia, Japan is also an active supporter of APEC and wants the East Asia Summit to become the most important East Asian regional integration body. China's regional interests are less clear and China was not as strong a supporter of Australia's inclusion in the East Asia Summit.

Japan's new assertive approach also carries serious risks for Australia and its goals of simultaneously being on the "best terms ever" with China, Japan and the United States *and* of being included in East Asian deliberations. A nightmare scenario for Australia would be an Asia Pacific where Japan, China and the United States are very wary of each other and their formal or assumed allies.²⁰ Australia obviously never wants to have to make a choice between China and Japan or China and the United States or have its alliance with the United States seen as a mechanism to contain and constrain China.

Unconventional Japan

Japan's three transformations means that the conventional wisdom on Japan is more often wrong than right. Unlike the 1980s and the 1990s, Japan today cannot be easily catch-phrased. On one hand, Japan is not "number one", and the "sun is not rising." On the other, Japan is not "number zero" and the "sun has not set." What we can say is that Japan's decade of paralysis, hand-wringing and soul-searching is coming to an end. Japan is becoming more assertive and more directly self-interested. Japan's balance sheet recovery and the executive-driven political system mean that Japan is more interested in activating its undeniable power potential at a time when East Asia's power landscape is becoming more fluid and Japan, for the first time in post-war history, faces a legitimate regional leadership rival. These trends should fix our attention.

¹ J.K. Galbraith, *The affluent society*. Boston, Houghton Mifflin, 1958.

² Business cycle dates presented in this paper are based upon the 'dating committee' of the Working Group of Indexes of Business Conditions within the Economic and Social Research Institute of the Japanese Cabinet Office.

³ Richard C. Koo, *The economics of balance sheet recession and yin-yang business cycles: a lesson from the Japanese experience*. Tokyo, 2004, Nomura Research Institute Occasional Paper.

⁴ See for example *Lehman Brothers Global Economics: Japan Weekly*, week beginning January 6, 2006; IDEA *Global Financial Markets Today* February 3, 2006. Nomura Japanese equity research, February 2006.

⁵ All land price data are taken from the Urban Land Price Index of the Japanese Real Estate Institute.

⁶ Please see Michael L. Gerlach, *Alliance capitalism, the social organisation of Japanese business*. Berkeley, University of California Press, 1992. Hideaki Miyajima and Fumiaki Kuroki, *The unwinding of cross-shareholding: causes, effects and implications*. Tokyo, 2005, Research Institute of Economy, Trade and Industry Discussion Paper.

⁷ The most widely cited survey is the Bank of Japan's venerable *Tankan* survey. Others of note include the Shoko Chukin Bank small business confidence index, the Ministry of Finance's business sentiment index, the Nomura-Reuters-JMMA purchasing managers' index and the Cabinet Office's Economy Watchers' Survey.

⁸ The "current account balance" target referred to here is a portion of the Bank of Japan's own balance sheet. The target level of funds under QE therefore becomes a part of the monetary base. The target level of ¥30 to ¥35 trillion represents almost one third of base money. This concept has nothing to do with the current account of the balance of payments.

⁹ The Japanese fiscal year ends on 31 March.

¹⁰ *Uridashi* is the Japanese translation of eurobond. *Uridashi* issues are denominated in foreign currency, allowing Japanese investors to access higher yielding offshore bond markets, and the bond issuers to access Japanese savings. Supranational organisations such as the World Bank are major issuers in this market. The marketing and distribution is undertaken by Japanese securities firms.

¹¹ The Chinese exchange rate was fixed at 8.28 yuan to the US dollar until July 21, 2005. Therefore performing correlation analysis on movements in China's spot exchange rate and those of other Asian countries prior to this period would be a fruitless exercise. Therefore we have used daily changes in the offshore non-deliverable forward market for the yuan as a proxy.

¹² Malcolm Cook, *Japan's party system: shifting the political axis, releasing economic reform*. Sydney, 2004, Lowy Institute Issues Brief.

¹³ Christensen, The new Japanese electoral system. *Pacific Affairs* 69 (1) 1996.

¹⁴ Peter F. Drucker, In defense of Japanese bureaucracy. *Foreign Affairs* 77 (5) 1998.

¹⁵ Tomohito Shinoda, Japan's cabinet secretariat and its emergence as core executive. *Asian Survey* 45 (5) 2005.

¹⁶ *Ibid.*

¹⁷ Yasuhiro Nakasone, Japan should retain male-line imperial tradition. *Yomiuri Shimbun*, 29 January 2006.

¹⁸ What a difference a month makes: 50 years of the LDP. *Japan Times*, 10 October 2005.

¹⁹ Boon Lai Hau, Japan flexes its diplomatic muscle. *Straits Times*, 1 December 1999.

²⁰ This proposition has been forwarded in relation to recent FTA negotiations with China. Some commentators felt that the concluding of the US-Australia FTA was inimical to a cordial agreement with Beijing. This argument has lost substantial momentum due to the relative success of Sino-Australian FTA talks thus far.

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ABOUT THE AUTHORS

Dr. Malcolm Cook, Program Director Asia Pacific Region at the Lowy Institute for International Policy, completed a PhD in international relations from the Australian National University, and holds an MA in international relations from the International University of Japan and an honours degree from McGill University in Canada.

Before moving to Australia in 2000, Malcolm lived and worked in the Philippines, South Korea and Japan and spent much time in Singapore and Malaysia. Before joining the Institute in November 2003, Malcolm ran his own consulting practice on East Asian political and economic policy risk analysis. Malcolm can be reached at mcook@lowyinstitute.org

Huw McKay, Senior International Economist, joined Westpac's Economic Research team in the year 2000. He is the Bank's spokesperson on pan-Asian economic and market issues.

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