Revitalization of the Japanese Economy and Its Implications for U.S.-Japan Relations

A CSIS Japan Chair
Conference Report

March 16, 1999

Center for Strategic and International Studies
Washington, D.C.

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March 16, 1999
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CSIS, Washington, D.C.

Opening Remarks

Robert B. Zoellick
President and CEO, CSIS

We are very pleased to be able to cosponsor this conference with KKC and particularly to have Mr. Kobayashi with us today. He and I had a chance to sit next to each other at the recent trilateral meeting, and I watched him chair what was a fascinating panel about developments in East Asia. I am very glad that we will now have an opportunity to hear his perspectives on economic changes in Japan.

I personally place great importance on the U.S.-Japan relationship and, during the transition process here at CSIS, have tried to reach out to those in the U.S.-Japanese community, as I think that this relationship will, if anything, be more important in the years ahead than it was during the Cold War period. It will be important both regionally and globally, and it will be important in economic and security terms. One only has to look at the newspapers in the United States and see the attention to China and uncertainties in North Korea to recognize that the U.S.-Japan relationship has to be the cornerstone of our policy in East Asia, including with China and in Northeast Asia. Indeed, one of the points that I made at the Trilateral Commission was my hope that we will be able to develop a greater three-way relationship with the United States, Korea, and Japan, at the same time that we try to reach out to China.

Now, today's meeting will focus on the economic relationship. This is obviously important for global growth today, but also for the international trading system, which I think will be the key component of the revival of countries in East Asia, Latin America, and Central and Eastern Europe.

Confidence in the Japanese economy has obviously slipped over a number of years. I personally believe that over the long term Japan's prospects are very, very strong, but there are clearly some hurdles to overcome.

Now, most of the attention over the past 12 to 18 months has focused on the stimulation policy and the questions of the banking system. We have got some first-class experts to talk about that this morning. I personally hope we are about at the point where recovery will start to take hold in Japan. Then, I think the question is whether the recovery can be maintained, and on that point, I would like just to mention three topics that I think may be important to Japan's economic recovery over the long term.

The first is the question of structural change in Japan. I believe we are actually seeing some breakdown in part of the old Japanese system that goes beyond a question of cyclical change to a change in relationships between the banks and the corporate structure. I think part of this is driven by the problem in the banking system where the banks can no longer afford the lending policies they had in the past for corporations. Corporations will increasingly need to look to other sources of capital. This change, in terms of the demands of capital for Japanese corporations, will be reinforced by other changes in the Japanese market, in particular, the deregulation of the asset-management market where companies like Merrill Lynch and Alliance

Capital are playing a much more active role in terms of the management of Japanese pension funds and other assets. This will, in turn, create a new dynamic for Japanese firms focusing more than they might have in the past on return on equity. This is a topic that Kobayashi-san and I actually talked a little bit about last July. Companies that can no longer rely on bank loans that enabled them to have a multiple series of objectives of market share and employment, as well as return on equity, will now need to focus increasingly on return on equity as an objective. This will drive other changes in Japan, including those in the nature of deregulation, competition policies and structural change. As some of you know, MITI, among other Japanese offices, as well as the Prime Minister's Office, is looking very closely at these changes to see how these components will be part of an overall restructuring of the Japanese economy.

Now, these are going to be extraordinarily difficult changes. One always has to be careful in drawing comparisons, but the United States went through wrenching structural change in the 1980s, even at a time of relative growth. I think one of the challenges in Japan will be to manage these long-term changes while going through a cyclical adjustment.

A second point is that the changes will proceed more effectively, and frankly, workers can be helped, if the restructuring includes opportunities for foreign direct investment in Japan.

In my current position, as well as in some of my past positions, I have had the opportunity to meet a number of senior American business executives, and I have been encouraged that a number of them have, over the past year, looked with increasing interest at investments in Japan. In fact, if you look at the foreign direct investment statistics in East Asia, Japan has drawn more funds over the past year than the other countries. I think some U.S. firms see the present situation as an opportunity to buy into distribution networks for a long-term investment. This, obviously, can be important in terms of Japanese employment. It can be important in terms of bringing competition. But I think it also has two long-term benefits for our countries. One of them is that, as we have seen in the case of the U.S.-Europe relationship, trade increasingly follows investment. As companies operate in different countries, the trade relationships often reflect intracompany transfers as well as knowledge of marketing. As more U.S. and foreign firms are able to invest in Japan, I think we will improve the trade situation, and frankly, there is a political element, as well, in that U.S. and other firms in Japan will become constituencies for the relationship with Japan.

Look again at our tension with China. Among the forces that are urging an ongoing U.S. relationship with China are those U.S. firms that are investing in China and see it as a long-term interest. This certainly is the case with the U.S. relationship with Europe, and I think it can be a component of improved relations with Japan. So perhaps the difficulties will provide an opportunity.

Third point. As some of you know, CSIS did a project last year that focused on our Social Security system and retirement and pension program through which we were able to bring together members of both parties on a packaged solution for reforming Social Security. It is now one of the major legislative alternatives in dealing with Social Security. We took that idea and started to expand it globally to look at the effects of aging on policy issues around the globe. This clearly is an issue not only for the United States and Europe but also for Japan. This will be a particularly important issue for Japan, because, as you look at the age distribution in Japan, it will have significant effects on everything from capital markets to savings, to questions of pension policies, and even questions of consumer psychology and attitudes of the society. So one other topic that I hope we can be involved with, in addition to trade and investment and the standard economic issues, is looking at the effects of aging policies globally.

I am very pleased that we have an extraordinary group of speakers and panelists here today. Our next speaker is Undersecretary Geithner, whom I have had an opportunity to meet over the years. I am particularly proud that he started as a civil servant in the Treasury at the time that I was there, and he is a classic example of a rising star, a professional that has served in a number of administrations. As I think a number of you know, he served as a deputy financial attaché in Tokyo, so he knows Japan firsthand. Then he moved on to positions as senior deputy assistant secretary for international affairs at our Treasury Department, and assistant secretary, and most recently, undersecretary. So he is a person of extraordinary talent, and I am very glad that he could be with us today.

Keynote Speech (U.S.)

Timothy Geithner
Undersecretary of State for International Affairs

I have to confess a bit of trepidation about speaking in public about Japan these days. Part of my reservation comes from the MacArthur Syndrome. Every time we at Treasury say anything about Japan, we are accused of trying to micromanage or dictate economic policy or otherwise trying to compromise the sovereignty of the world's second-largest economy, and this makes it difficult for us to say anything that is not interpreted as being offensive.

There is also a sort of cloud of staleness over policy discussions about Japan in Washington these days. In part, this reflects the old conviction that there are really no new economic policy issues with Japan, only recycled fights about issues like the unique quality of Japanese snow disqualifying imports of foreign skies or about relative blame for our trade imbalances. But it's also true that the debates about Japan policy these days don't have the heat of the old fights between the doves and the hawks, between the Chrysanthemum Club and the Revisionists. The edge, the sort of fear that fed the policy debate when everyone thought Japan was about to take over the world economy, has been replaced by a sense of fatigue.

I'm not sure what the source of the new mood is, but whether it's due to a sense of stalemate in Japan, or to the end of the Cold War period, or to the new U.S. triumphalism over our relative prosperity, there now seems to be a sense almost of indifference to Japan, at least in comparison to the intense focus of a decade ago in this country. To some extent that indifference is evident in Japan, where it seems to us there is sometimes a curious lack of intensity to concern about the economic outlook and the trade environment and the cost Japan's policies present to the rest of the world.

This is unfortunate, in my view, because what is at stake today in the economy of Japan is, in some sense, greater than it was in that earlier period of concern about Japan's strength. Although the risks seemed more acute to many when the dominant concern was with the implications of Japan as an ascendant economic power, in some sense the present period of economic weakness in Japan presents greater risk to the system.

Now, much of U.S. policy towards Japan over the past 25 years or so has been shaped by the challenges Japan has presented to the world in three areas. First, its relative openness or lack of openness to trade and investment with the rest of the world; second, its macroeconomic policy balance and the implications of that balance for external surpluses and deficits and for exchange rates; and third, the degree and quality of its financial involvement with the rest of the world. I think these are still useful frameworks against which to evaluate where U.S. interests lie in this relationship.

By some measures, Japan is more open to trade and investment today than it was a decade ago, but these changes have been relatively modest in magnitude. If you are a manufacturing company or an agricultural exporter of certain products, whether Thai or American, you are probably still more impressed with how difficult it is to compete in Japan than how much more opportunity there is now, particularly if you compare the ease of access to Japan against access to the U.S. and European markets. The perception of a fundamental asymmetry in the nature of Japan's interaction with the world economy, the sense that Japan is a significant beneficiary of access to the markets of its major trading partners without providing a comparable commitment to openness, still permeates much of outside perceptions toward Japan. Although in

economic terms Japan may suffer more than its trading partners from this asymmetry, the sense of unfairness is still a significant complication in the efforts of this or any administration to preserve and strengthen the consensus in favor of open trade policies in this country. This perception is relatively dormant now, masked by our relative prosperity, but it is unlikely to have faded permanently.

What makes this apparent disparity and openness enduring is the different approach Japanese society and policymakers bring to economic change itself. U.S. policy is still dominated by the belief that we prosper only through accepting the change that technological development and trade bring, and that systematically trying to resist those changes and insulate companies and workers fully from the effects of those changes would fundamentally damage our economy as a whole. In Japan, I think it is fair to say that this view of economics still has a fairly tenuous hold on policymakers. The traditional inclination to preserve the stability of some sector or entity, even at the expense of the whole, is still strong, and it is this choice that makes trade protection in Japan seem so resistant to change.

The trade policy environment between our two countries is different in many respects today. We now have bilateral trade agreements covering so many of the potentially contentious areas of trading goods and services. There is no longer this conspicuous pipeline of new issues to be fought over, and the nature of what preoccupies our bilateral agenda has changed to disputes over enforcement and interpretation of agreements.

The frontier of the trade agenda between our two countries has shifted, too. Some would say it has returned to the deeper problems of deregulation and structural reform where change is more elusive, where success is harder to define, and where our capacity to effect change is likely to be even more limited than it is in the traditional area of trade restrictions.

These changes leave us with what, on the surface, looks like a less contentious trade relationship, but it would not be fair to claim that this reflects some sort of fundamental achievement of trade negotiations. It is probably more fair to say that while the object of the negotiations has changed, the underlying source of the problem is still significant. How significant is something we will only be able to assess if we enter, in this country, another period of relative economic distress and insecurity.

Now, the second challenge that has shaped much of our policy engagement with Japan is in the realm of macroeconomic policy. The last couple of decades have been marked by episodes of substantial macroeconomic imbalances between our two countries. The adjustments forced by the ebb and flow of these imbalances have, at times, been quite damaging for the system, and the pressures that build behind these imbalances are a growing source of concern today. Sometimes, these imbalances were principally the result of some U.S. policy failure or adverse policy mix in this country. Other times, like now, these imbalances are the result, primarily, of some policy failure in Japan.

Now, the question of how to limit the potential for the emergence of imbalances of this scale has been the subject of many debates about policy cooperation and coordination in the system. This objective has driven several attempts by U.S. administrations to seek to impose constraints on Japanese policy or to induce changes in Japanese policy, either through exchange arrangements or systems of cooperation anchored in policy commitments. Some of these attempts were based in the G-7. Others were primarily bilateral. Some have had modest periods of success. Some have brought perverse and quite damaging results.

Now, the present administration has approached this problem with less attention to grand design and formalizing exchange-rate arrangements and more attention to policy to try to induce

changes in underlying policies in Japan that would be likely to create a more balanced pattern of growth, help avoid a reemergence of large imbalances, and as a result, help create conditions more conducive to exchange-rate stability.

This is hard to do with any country in any circumstances. It is particularly hard to do in Japan today, because of the complicated nature of the policy channels that Japan faces. It is not just macroeconomic policy, but as Bob Zoellick said, it is a much more complicated mix of structural problems that have macroeconomic significance. And it is harder today because of the way politics in Japan and the relationship between the Finance Ministry and the central bank and the political establishment in Japan has changed. These are changes that make Karel van Wolferen's famous line from about 15 years ago that there is no center in Japan seem like an understatement.

There have been significant changes at the margin in the policy in Japan over the past few years. It is hard to say, however, given the performance of the Japanese economy, the current level of imbalances, and the degree to which the real effect of exchange of the yen has moved over the past five years, that this approach to cooperation has been particularly successful. And yet, the U.S. economy, over this period of time, has performed exceptionally well. It might be tempting for some to conclude from this that, if we just continue to worry about our own fundamentals in the United States, that will be a sufficient condition for U.S. economic success—and that somehow we or others have exaggerated the impact that economic problems in Japan and other countries have for the United States. But, I don't think this would be a sensible conclusion. Japan's protracted weakness has contributed significantly to the depth and intensity of the problems facing Asian economies and, to a somewhat lesser degree, to the broader emerging market financial crisis. Parts of the U.S. economy have been hit quite hard by the direct and indirect effects of Japan's distress, and the full effects of these changes will not be apparent until we see how the inevitable adjustment in our current imbalances takes place.

It's obviously in our interests, in Japan's interests, and in the interests of the world economy as a whole that this adjustment takes place primarily through an acceleration of growth in domestic demand in Japan. Yet, the fact that there is a coincidence of interests in favor of this policy mix by itself won't deliver the necessary policy change in Japan. The challenge for us is to find ways, in a world of individual sovereign states with elected parliaments and independent central banks, to induce changes in the policies of our trading partners that are consistent with our interests and those of the international economy as a whole and to do so in ways that do not constrain our capacity to pursue policies that are in the best interests of our economy at any point in time. The gap between the interdependence that integration brings and our capacity to limit the potential for adverse effects of developments in other countries on our economy is going to remain a central preoccupation in our relationship with Japan.

I wish I could say we have a secret, elegant plan for dealing with this gap, but of course, we don't. The fact that Japan has proven peculiarly indifferent to the costs that its policies impose on the rest of the world, even a world as delicate as the one we now face, makes this problem more discouraging. And the fact that this may have been true of the United States at times in the past doesn't make it easier to accept in Japan today.

The third area of preoccupation in our economic relationship with Japan over time falls into the category of financial diplomacy—the extent and the quality of cooperation we have between us in making the international financial system work. Over the past several decades, much of this part of our relationship was dominated by a debate over burden sharing, with the United States urging Japan to bear a share of the financial burden more commensurate with its

relative wealth, and this is an area where Japanese policy and practice have moved a long way. Whether you look at Japan's ongoing financial participation in the international financial institutions (IFIs) or at the scale of its direct bilateral contributions to countries affected by the present financial crisis, it would be hard to argue that Japan contributes less, in terms of the quantity of the assistance it provides, than what might be fair by some objective standard. There are still many critics of the quality of such assistance and the appropriateness of the conditions that sometimes come with it, but the scale is unassailable both in absolute terms and in comparison to what we do.

It is also fair to say that for much of the not-so-distant past we shared a rather similar perspective on policies for financial intervention and crisis, for the operation of the international financial institutions as to how to deal with debt problems of sovereign countries, and for other in the broad universe of issues. This helped make smoother than it might otherwise have been the emergence of Japan as a much more dominant financial force in the international arena.

When I first came to Treasury, the assistant secretary said that we were probably more likely to be in agreement with Japan on any issues on the G-7 agenda than with any other G-7 countries, even Canada and the UK. Although I think it is probably still true in some respects, Japan's approach is changing in potentially important ways. There's a bit more these days of what you might call the Ishihara Shintaro imperative, which is, if the United States is for it, then maybe Japan should be against it. There is more force and creativity now behind Japan's perceived Asian imperative and the effort to cement in the region a larger role than it currently enjoys. There is more reluctance now to devote significant financial resources to problems outside the Asian region. There are new attempts to try to gain influence in the IFIs to counteract what's perceived to be excessive U.S. weight. There are occasional whispers of concern about the Washington conspiracy and our supposed intent to defend the interests of Wall Street at the expense of developing countries in Asia.

The advent of EMU in Europe and its subtheme of counteracting U.S. hegemony has a Japanese echo, and Japan increasingly brings to the G-7 and to the boards of the IMF and the World Bank a different perspective to what we might bring to the questions of basic approach to economic policy in emerging economies and the conditions that apply to financial assistance, etc. These changes and the forces behind them, I think, are quite significant, and they will make the financial diplomacy between Treasury and the Finance Ministry and between the United States and Japan more complicated and more interesting than it's been in the past. We could never have taken cooperation for granted with Japan. We can't afford to do it now, and, increasingly, we will have to win it and induce it rather than simply expecting it.

Our economic agenda, as you can see from this, is kind of straightforward and simple. We want to see a Japan emerge that is more open to trade—still more open to trade. We want to see it succeed in fixing its financial system quickly. We want to see it succeed in restoring strong, sustained growth in domestic demand quickly, and we want to see it continue to play an active role in strengthening the institutions and networks of cooperation at the center of the global financial system in cooperation with the United States. Because of Japan's importance to the world and the state of the system at this moment of crisis, we have a huge stake in seeing this happen. The question is how to encourage it and to induce it, and that's something I hope you're able to figure out in the rest of your session today. Thank you very much.

Q&A

Q: There's beginning to be information coming out of Japan in recent days that finally enough money is sloshing into the Japanese economy, finally a czar of banking recovery has been appointed who may be carrying out the job, in fact. What do you think? Has anything happened to improve the situation?

A: I think it's absolutely true that policy in Japan has moved quite decisively over the last year in the direction that most people think is sensible. There's a lot of fiscal policy now in the pipeline. You're seeing a potentially significant shift in the direction and objectives of monetary policy, and there is now in place a much more powerful set of institutional arrangements for dealing with the financial system's problems than had been in place a year ago—and those arrangements are being applied in some ways with more force than people had expected. All those things, I think, are good.

It's still true, however, that private sector forecasts for growth in Japan next year are slightly negative, and I think there is still a considerable degree of uncertainty about how the economy, which has not been significantly ameliorated yet by the shift in policy, is going to fare over the short and medium terms. It's true that there's a bit of parting in the clouds of pessimism over Japan now, but that happened many times over the last several years, and the effects haven't always been enduring. So I think it's hard to tell at this moment how powerful or successful these changes in the pipeline are going to be.

Q: According to both the *Washington Post* and the *New York Times*, the latest report on the fourth quarter GDP of Japan, which showed greater-than-expected negative growth, severely undermined the credibility of Japanese officials, including Mr. Sakaiya who happens to be a good friend of CSIS and who made a series of hopeful comments on the Japanese economy.

First of all, do you believe that they should stop trying to talk up the economy? Secondly, how would you respond to the latest assessment by the Economic Planning Agency (EPA) of the Japanese economy, which is, and I quote, "the economy is gradually bottoming out."

A: I don't think I have anything to say to that other than what I just said in my previous answer. It's just hard to know at this stage, with much confidence, how the real economy is going to fare in the short term. It is very significant how much policy has started to move, but it's natural that the effects of that policy will only be realized with a lag, and it's hard to tell at this stage where you are in the lag.

I think most people would say that fiscal policy is now powerful enough to start to put a floor under demand (as every point over the last five years, it's been used with force), but that is probably not a sufficient condition for recovery. I don't have any specific comment on the forecasts of the EPA. What we try to do is look at a consensus of a broad variety of forecasts by the private sector as we think it is the best measure of sentiment and how sentiment is changing. If you look back over the past five or ten years in Japan, those have been a much more reliable indicator of the performance of the economy than have any other forecasts.

Q: But, you were saying that the Treasury tends to pay attention only to a pessimistic forecast.

A: Actually, that is not true. It was true when I was in Tokyo. It's true that we spent a lot of time looking at Japanese forecasts, and what's interesting about Japan now is that there's not the kind of disparity that used to exist between the forecasts in Japan among private and foreign analysts in institutions. There's much more consensus and convergence now than there was in the past. Places like the Japan Center for Economic Research now forecasts zero growth in Japan for 25 years. So there's not a division now between foreigners lost in some confused pessimism about Japan and how people view things on the ground. We're not pessimists by nature. We're kind of cautious by nature but not particularly pessimistic.

Q: You have talked at length about the closed or open nature of Japanese trade policies. Aside from those kind of factors, I think one of the major issues that has been discussed in the past is the difference in the savings rate between the two countries, which will cause imbalances in the current account. Right now, the Japanese savings rate is very high. The U.S. savings rate is dropping. How do you think that will effect the imbalance in the current account?

A: You're absolutely right that relative openness between our economies has little to do with the scale of the imbalance, and the amount is mostly a reflection of the savings and investment gap in our two economies. Our imbalance now, in contrast to what's been true in the past, is more a reflection of the fact that we've been a shrinking island of prosperity in the world and not that we've been irresponsible fiscally or consuming excessively. And that makes even this level of imbalance for the United States of somewhat less immediate significance than in the past.

It's true that private savings in Japan are still quite high, but what's impressive about Japan has been the absence of investment and lack of investment opportunities. If you think about economic policy in Japan now, it's really about what kind of changes would bring about an increase in perceived investment opportunities in Japan, so that you'd see that imbalance between savings investment start to diminish. Our view has been that you're probably not going to see that happen until you see the adjustment to the bubble fully pass through the system and a set of macro policies and structural policies in place in Japan that will both induce more demand and help create more opportunity for investment through deregulation and other measures.

Keynote Speech (Japan)

Yotaro Kobayashi
Chairman and Co-CEO, Fuji Xerox Corporation, and
President, Japan Committee for Economic Development (Keizai Doyukai)

What I would like to talk about is not necessarily just a private-sector view, but one mixed with my personal view about what is currently happening in the short term in the Japanese economy—and what is required to sustain this recovery into the medium term and long term, specifically in the area of structural changes.

On this question of revitalization of the Japanese economy, I would like to say at the very beginning that there are two components that we have to be very keenly aware of. One is, of course, the short-term component, which everybody is interested in. I wasn't particularly happy with the way Mr. Geithner described the current Japanese attitude, such as indifference to the cost of the Japanese economy to the rest of the world. I don't really think it's indifference. We are struggling but not exactly indifferent. The short term is certainly very important, but we have to follow this short-term recovery with measures that will prolong the recovery into the medium and long term. This is where the structural changes are required. Mid-term changes will certainly involve many of the structural changes or deregulation that are being discussed and are probably to be done in the range of the next five to ten years.

But there is also another issue, probably the most important and maybe the most challenging element of revitalizing the Japanese economy and perhaps also the Japanese mentality and thinking in general. It's a question of the mindset, and it covers areas like education. I don't think I will have the time to go into the details of what is being done in educational reform, but I will touch slightly upon it, and maybe we can cover that in the question and answer period.

In regard to the short-term recovery, I don't think I have anything to add to what has been said by both Mr. Zoellick and Mr. Geithner. There is a question about the negative growth in the fourth quarter calendar, not fiscal calendar. The outlook for the fiscal year 1998 is a little worse. In defense of Sakaiya-san, the new minister of EPA, he was the one who really forced EPA and the government to come out with a more honest outlook for FY 1998, and admittedly, the first honest answer was a minus 2.2. It's going to be like a minus 2.6 or 2.8, but still I don't think it is going to be minus 5. We will have to watch the fourth quarter very carefully, but at the moment, what I hear generally is that the fourth quarter of FY 1998 won't be that bad. FY 1998 will be in the minus high 2 percent area, but that's not too far from the first estimate that Sakaiya-san came out with.

There are a number of positive signs. Bankruptcy is down, and there's some upbeat news in spending. Of course, as Mr. Geithner said, the most worrisome area is the continued extremely slow growth in industrial investment. But, again, this is what we have to expect as a result of huge excess at the facilities that we have, in addition to excess employment. They are the two major issues that we have to deal with to get over the current economic slump and into the next phase. This, particularly the adjustments dealing with excess employment, is the major issue in the area of structural adjustment, particularly in the private sector.

Regarding the financial area, I think the *Washington Post* had the big picture of Mr. Yanagisawa today, and the story tells pretty completely where the situation stands. The jury is still out as to whether these banks will come out with, in the words of Mr. Yanagisawa, a John

Reed type of response to the challenges—the leaner and more productive organizations that all these heads of banks said they will have before being approved for public money.

The short-term, bottom-line message is there are mixed signs, but my feeling is that it is better than before. My feeling is the situation has bottomed out, but it does require very close watch and continued action both from the public sector and, especially, the private sector.

In the public sector, we all know the government has done tremendously in terms of its stimulus package. Do we have more room in fiscal policy, aside from maybe pushing forward some of the tax reductions? The general view is no. I think we're already on the verge of having an extremely dangerous fiscal situation.

Mr. Higuchi's Economic Strategy Council came out with a package that says that by 2008 we will recover our fiscal health, but until then we'll probably be playing out the stimulus package, continuing to recover fiscal health in the short term.

The interesting part of that package was that the commission placed an extremely strong emphasis on the need for a very good social safety net, particularly designed to address the discretion of employment or unemployment.

There have been a number of discussions this year and even a few years back, about bringing in the portability of pension and retirement plans, but this idea is still meeting with very strong resistance, not really from the bureaucrats but the unions. I think their reasoning for that is that approving portability means rubber-stamping the creation of a strongly flexible labor market. But I think most people agree that what we need in Japan is not the static security of jobs but a more dynamic labor market, where, again, restructuring is required. Everybody knows that there will be no permanently healthy industry or company. There will be structurally affected industries that will have to go down, and we will have to change the combination of industries, as we did immediately after the war, from light industry to heavy industries in the last 20 years, and gradually from manufacturing to service. In the past, the shift had some impact on employment, but because the general mode of the economy, not only in Japan but throughout the world, was growth, the impact was not as great as we are currently expecting to have in the next few years in this fairly slow economic growth mode with major restructuring of industries. But, it is absolutely necessary for us to go through this.

We are already seeing some visible signs of restructuring by major corporations. I think these are probably good signs, but even companies like NEC and Sony are telling the Japanese people that even they, the blue chips of the blue chips, are not free. They're not immune from many of those changes that are necessary if the companies are to continue to be competitive. I think it is a very, very important lesson that people are learning gradually, and this is very positive news.

On the other hand, the president of Toyo Rayon, Mr. Ito, said, "We will not publicize our restructuring. This is strange that the stock market acts possibly to news of restructuring or under-sizing of companies. We will go through that plan as we planned. This is not the subject for publicity." It is a different philosophy, but interesting, that the market in Japan is greatly influenced by investors outside of Japan reacting to these changes.

In a similar way, the stock market in this country has responded to the so-called aggressive restructuring, reengineering, and downsizing plans of many corporations, including one I know very well, Xerox Corporation. This probably shows one aspect of the Japanese economy becoming global. You can use a term like "global standard" in any way you like, but I think the investment standard of, particularly, large institutional investors in Japan is assuming qualities and characteristics similar to investors in the United States or elsewhere.

In the private sector, particularly in 1999, at places like Keidanren and also Keizai Doyukai, where I'm currently sitting as one of the vice presidents, there is a very strong feeling that this is our time. We have asked the government to do what they have to do, and they have done their share. I think the U.S. and other governments openly admit that the Obuchi government has taken very bold actions, surprising many people. What does the private sector have to do now? One thing is, although it is going to be difficult, we have to go through with our own restructuring plan. That doesn't automatically mean that we have to slash the level of employment. We will have to face that, too, but we will have to deal with it in a very classical, orthodox way by trying to come up with the best and most creative technology, services, and products.

There are people who say, "Japanese have enough already. What else do we have to buy?" That's nonsense. That's never been true; maybe only in the last several years where the economy has been really slow. There have been long lists of so-called kit products, where you just cannot produce enough. The fact is, yes, people have plenty, but there is room for the private sector to come up with something attractive enough to go beyond that level, telling consumers, "This is something special. You may have something, but this is not the same as what you have."

The second thing is in order for this to happen a lot of companies are having second and third thoughts as to how they utilize people's abilities. As you know, and this is a gross generalization, for a long time, industry wanted people right out of school, who would be cooperative, team players, happy to work long and hard, not be too different, not too creative, and not too individualistic. But now, when there's demand for something creative and different, the situation automatically tells you that to have something creative, you need creative people, both within and maybe outside companies. Responsible companies are looking with fresh eyes to some of those people who have not been utilized fully in that sense, and this is very important. Maybe we have overlooked some of the potential that has been present but latent, not fully utilized. With the new way, we can probably come up with something that will be not just more efficient to buy, but different, interesting, and attractive. This is a very important and new drive that is going to be required. I think it is going to be one of the keys for many private sector companies to stand out from other companies in the same industry.

But the most challenging area for all private sector companies is to go through downsizing of excess capacities in the physical sense. There are talks about prolonging the period to write off excess facilities. Many of the companies have to balance between the positive impact that such action will have on the stock market, for instance, and the negative impact on profitability. This is a very close call, and the situation will probably vary from company to company, but if basic confidence in the management and quality of the company is strong, probably the company will take those charges and losses in the short term. And it is easier to take action after doing so, as those actions will have positive impacts on profit in the third or fourth year on, instead of prolonging the losses. But, there will be some companies that will prefer that.

The social safety net is being discussed. It is interesting because about two years ago if you spoke about coming up with some measures in the area of social safety net vis-à-vis employment or anything else, you would have met very strong, at least pro forma resistance, saying, "Well, that will invite more hazards. That will make it easier for them to take hotter actions, and it will simply prolong the pain and difficulty arising from having excess capacity and employment."

I think today's sentiment in Japanese society, where rightly or wrongly, the people are so used to having a secure employment system, even at the expense of lower productivity and lower profitability, is like "Now, we have to work totally following market principles. We have to increase our profitability and productivity to the level of mediocre American companies. We don't have to be first rate, but the excess employment has to go. This is the marketplace. We have to accept it. It may be painful, but we have no choice." I'm exaggerating a little too much, but surprisingly, you hear even some Japanese talk in this manner.

My feeling is that most of the sensible Japanese people realize, at least conceptually, that, despite their unfulfilled desire that the economy would recover in time, they have to accept the fact that unless we do commonsense things like adjusting the supply level to the demand level, there'll be no future for our industry and jobs. And, therefore, providing a social safety net is going to have a very positive effect in terms of even accelerating and pushing the companies to take necessary action, but also to provide a safety net for those people who will be displaced.

The current government budget does include a fairly sizeable sum of money for education and retraining of those people who will be displaced. It will not be only vocational. In Japan, being prepared mentally for the physical relocation is going to be as important as changing jobs, and this is going to be a long-term process. But I think the reality of the marketplace is gradually sinking into the minds of many people. In that sense "indifference" is the wrong term to describe the general sense that is prevalent in Japan with respect to the cost to the rest of the world of Japan's slow recovery. Indifference is something that I do not sense is present in the Japanese market.

The government's official outlook for economic growth in 1999 is plus 0.5 percent. Most of the private sector forecasts a minus 0.5 percent. To me, it doesn't make much difference. I wish it would be in plus or zero, but it's just a couple of percentage points growth from minus 2.8 or minus 3 percent. I wish it would be a plus, and I think it pays for the leaders to take a positive attitude. As I said, a lot of actions will take place in the private sector, and the public sector is keeping a very close vigil on whatever must be done, if necessary, to continue the current mixed but still somewhat positive feeling on the part of people. Business's outlook into the future is much better than it was several months ago. It is the same with respect to outlook on the part of the people; although, that positive mood is still not reflected in additional spending either by individuals or corporations.

A few words on the long-term return. When we talk about structural reform and deregulation, of course, most people imagine what has to happen in the way government agencies need to change, meaning the regulation of many areas of the economy. I don't know what the number is now, but something like 44 or 45 percent of the Japanese economy has been under regulation, as compared to 6 percent in the United States. My good friend and associate at the Keizai Doyukai, Mr. Miyauchi of ORIX is the chairman of the committee on deregulation. He is not totally satisfied with the progress, but even a person like him admits there are many changes going on. Of course, it's not just the numbers we really have to change or count, but I think this trend will not slow down. Some people warn of quick, quantitative recovery, inviting more companies in slowly restructuring areas. I don't see that danger. I think there is a very strong feeling on the part of the private sector in favor of changes, and I do not really see the resistance winning them over.

But I also believe that the private sector has to go through another medium-term structural change in the area of corporate governance. We have many ills in the private sector, whether in banking or manufacturing, including a huge amount of nonperforming loans and

excess capacity, but there is a very basic question that has to be asked. Why have they been left unchecked for such a long time? Was that just management's incompetence? Were they so bad? The stark reality is that many of those unchecked decisions at the highest levels of corporations invited those results. The lack of transparency was also related to the structure of Japanese corporate governance. This really has to change, and it is happening. It's not just downsizing the board, but inviting outside board members, against the huge outcry of, "What do they know about our business?" It's interesting in Japan that those outside members who are invited to the board will work closely with the statutory auditors that you do not have. They may become redundant, but we may see an interesting combination of the outside directors and the statutory auditors coming up with a Japanese way of providing necessary transparency in the management of Japanese corporations. This has to go on.

We are going through a phase in which some of the former board members are asked to become corporate officers. Some take it as being removed from a very important social status, but I think this is only a matter of getting used to, because, in real terms, aside from the legal issues, many of them will stay at the very top. They will maintain the respect of the corporations. But, for the next several years, the change will require those people, and society as well, to get used to the new situation.

One word about longer-term issues. I think all the questions being asked in Japan come down to the question of governance. I talked about corporate governance. It really probably starts with personal governance, corporate governance, and of course, public governance, as a political system. Many of the changes that I talked about or are being talked about today do require political decisions—political decisions, not just by political thinkers, but backed up by voters.

It also comes down to a sense of values when we talk about U.S.-Japan relations, especially common values. We often talk about common values shared by our two nations, but I think at least on the Japanese side, we have to reexamine our sense of sharing many of those values with Americans. Do we really share them? Do we really practice justice, democracy, fair play, and market mechanisms? I'm not saying that we should be just like the United States, but what I'm saying is that we have to be certain that we do sincerely share and practice them at the level of corporate and personal behavior when we talk about sharing values.

This is a long-term overhauling of education. I am happy to report, however, that quite recently, based on the studies that started about 10, 20 years ago, major change has come into the education system from primary school to high school. It shows that students are more on their own, think about their lives, have their own ideas and thoughts, are not afraid of being different. Universities are reemphasizing the humanities and liberal arts to encourage students not only to be able to develop abilities to solve problems but, more importantly, to define problems. These are the new issues that need to be watched very carefully, especially by business. I believe very strongly, the business sector really has to take a large chunk of responsibility in encouraging our education system to produce more customer-oriented people and more creative individuals. The business sector didn't really want individualistic persons. So universities complied with the customary climate. High schools complied with the requirements that were necessary to get students into better schools.

As I said earlier, it will take 20 to 30 years to have these newly educated people performing in society. It's going to be a long-term project. Do we sit still until they come out to the society? Of course, the answer is no. Those of us who are already out in the world, not as

old as I am, but younger people, have to work to challenge these basic value issues, and I think all these will have a profound impact on the U.S.-Japan relationship.

In the short term, I'm not too concerned. Even if there are frictions and problems, I'm sure we can come up with certain solutions. I think what is more important is the longer term. I don't think the so-called French Ishihara Shintaro model is gaining ground in Japan, but it is a fact that it will be healthier if the current economic, financial, and technological dominance of the United States is more moderate. We need a little more balance. We are not asking for America to become less effective. It's up to the Europeans. It's up to the Asians.

The EU is coming through. I think it's a great historic event. Asians, I think, are becoming very prominent at the Trilateral Commission and are showing growing maturity, despite the current financial and economic problems. They're building on their part to participate very meaningfully in global affairs. Of course, we have a responsibility to match growth with maturity, not only in terms of delivering economic or financial packages. In relative terms, if our American friends perceive these as threats, it's wrong. I think all these mean creating necessary countervailing powers, using Professor Galbraith's famous term, and it will provide better balance for the future of the world.

I don't think Japan is there yet, and we will probably be able to recover from short-term problems in 2000 or 2001 with close to 2 percent growth, which everybody believes is a kind of a normal growth rate. But that's not enough. We should not stop there. Medium- and longer-term measures are absolutely necessary for us to revitalize and make Japan a meaningful partner to the United States in a new framework, and therefore, a meaningful, productive player in the world economy and world affairs.

Q & A

Q: I took heart in your talking about the need for more balance, both in the world and in Japan. I just want to take you up on the question of the roles of the various elements of Japanese society. You talked about the educational system and business community; you really didn't talk about the political system, except maybe in passing. I was wondering whether or not the kinds of changes that you so clearly point to can take place under the current political structure, which seems to have dug in its heels very strongly over the last 10 years against the kinds of changes that seem almost to be forcing themselves on Japan today.

Do you see the kinds of processes of change that are required going forward at some sort of reasonable rate under the current political organization, dominated by one party that has very definite roots in various parts of the community, some of which are resistant to the kinds of changes that need to be made? Under those circumstances do you see forces that are pushing in the direction of reform of the political system that will enhance the ability of the overall society to change in the directions that you pointed out?

A: My answer, in short, is yes. As you know, the political reform currently underway was initiated five years ago. There are several phases to it, but the important part was to change the electoral system from midsize to small size, in other words, change from a system in which one party, like the LDP, is running several candidates to a system in which one party is running one candidate. I hope that this will eventually lead to a system in which we will have a couple of

major political parties plus one or two where people can really exercise a choice, based on their policy preferences.

Are we there yet? Of course, the answer is no. We are not there yet. Are we moving in that direction? My feeling is yes. Currently, as many of you know, there is a rather unnerving discussion going on about going back to the old system, but most of the leaders at organizations like Doyukai and Keidanren believe that there are certain technical matters that have to be corrected and that this is not the time to go back to the old system. There's also a group of people who cynically say the Japanese are not equipped to make choices on the basis of policies, and therefore, the current system is nonsense. I do not agree. There are many who do not agree, and we will push the current system to reform although we don't have a very clear-cut situation where we can say which ones are for reform and which are not. Even the current coalition between Mr. Obuchi and Mr. Ozawa has made the situation somewhat more vague. We will be choosing certain specific policies in the next several years, as other speakers have mentioned, such as aging policy, including pensions and medical. Policies will become more specific, and I'm sure that we'll gradually have a situation where people will have a choice, depending on their choice of policies. I don't really know how many more additional elections we will require before that situation becomes clear, but my sense is that we are on the right track.

Again, I do not want to be cynical, but we are looking at many of the players and politicians in the political arena, and there are a number of young politicians participating in international forums. They are still in the junior ranks but are very attractive, international, straightforward, and logical. They make sense, and many of them are hard landing oriented. But basically they are for reform, and I think whether in the LDP or Liberal or other parties, they are gaining force. They are still up against all of the seniors, but I remain optimistic that the general changes plus the input from these young politicians will have a meaningful impact on the changes that are necessary and desirable for Japan and, therefore, the rest of the world.

Q: I'd like to pick up on what you've said about the need for Japan and for the Japanese productive system to develop new products, and what you've said about the aging of the population. We talk a lot about it normally as a microeconomic phenomenon and about its impact on savings and so on, but I wonder if you would agree that it's also a question of older people buying fewer products and more services. This is surely a trend that is going to continue in the Japanese economy for many, many years to come. If you're talking about investment in new capacities to deliver products, it's going to be increasingly in services. You've talked about the ability of the Japanese economy and the Japanese system to provide these new products, but particularly in services, the world's great exporters of services tend to be European and American. The expertise in many service areas is in Europe or in the United States. Is the Japanese economy going to be open to receiving services or borrowing expertise in service sectors from abroad? Surely, it's going to be more important that Japan be open to services than to cars or to flat glass in the future.

And a second point on the same subject, services are normally delivered either by people or through the telecommunications system, the Internet. Are older people in Japan, those over the age of 50, sufficiently computerized and computer literate to receive services through their screens, or will a big effort have to be made to make them computer literate? If people deliver services, how open do you think Japan will be to receiving foreigners into Japan to provide the services, as the years go by?

A: Three remarks. One is an assumption, and I'm not challenging you. The assumption that seniors have a lower propensity to spend was often discussed when the most recent tax reforms were being discussed in Japan. The original proposal was to lower the tax rate of the higher bracket, but a discussion of the more affluent being older and whether they spend more came up. Statistics show that in Japan older people do not spend as much as younger ones, and they spend not for themselves but for their grandchildren.

With respect to the second question, recent book suggests that we should not be afraid of new technologies and should not be afraid that we're not up to using them, because history tells us that new technologies are always more user friendly. I think it is not overexaggerated. I think older people are capable of using computers, but they are not computers.

Will the Japanese be ready, if that is the case in order to learn, to bring non-Japanese people in? I think the general answer is yes. Of course, the question remains as to how many, at what pace, and whether those people will be capable in the Japanese language or not. I think the general answer must be yes. There is a growing sense of urgency in Japan to keep up with the world of the Internet, and the need is very real. How to cope with the aging sector of society, 50 years old and beyond, is a big challenge. I think current emphasis is more on furnishing schools with computers and access to the Internet, but what about the silver market? Are they being provided with the skills? I think the answer is generally yes but not as much as needed. That's something that I have to look into a little more carefully.

PANEL DISCUSSION

Prospect for Japan's Financial Restoration

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For some time I've been sort of in the default position of being the optimist on Japan, because I believed there was only about a one-third chance Japan would fall into the ocean, and in both Japanese and American circles, that was seen as a radically optimistic statement. But everything is always relative, and today I think we're all in the position of being relatively optimistic, because we think it looks like Japan is bottoming out, and God alone knows what's going to happen to the EU in the next six months. But let's try to be a little more specific.

I'd like you to consider the situation the Japanese economy finds itself in at the moment, in particular Japanese economic policymakers, and I'd like you to consider the image of a ski jumper at the top of a ramp. The ski jumper wants to get maximum lift for the furthest distance at the end of his ride, pushes off very strong, holds himself in a tight tuck and tries to get all the way to the end of the jump. I use this sport, because, after extensive consultation with someone at the Japanese embassy, it seemed that this was a sport most Japanese people understand, as opposed to, say, football.

Anyway, think of the Japanese government and Japanese economic policy as the ski jumper, and what you'll find is that if the Japanese government carries through on its current list of policies, it will actually be doing exactly the right things. It will be giving itself a very big push in the form of fiscal stimulus. It will be making sure that it stays in good form by cleaning up the financial system, and we hope at the end it will lead to a big takeoff. I just want to second something that came up in both Mr. Kobayashi and Undersecretary Geithner's remarks: the fact that the track of the economy does what a ski jumper does, which is to come down to take off. In other words, the fact that there's some lag between when you make financial reforms and when you put fiscal stimulus in the system—and that you get the actual growth on the other end—should come as no surprise. So I think we were all unpleasantly surprised by the Q4 numbers. I think all of us were serious about this, recognized there were a lot of screwy things in the Q4 numbers, and don't necessarily need to take that as indicative of anything in particular.

But what I'd like to focus on is why I think the fiscal policy is actually reasonably good at the moment and why I think the financial cleanup is actually extremely good. I'd like to turn to the monetary side, because I think that's the critical issue right now.

When you're going on a ski jump, the last thing you want is your best friend yelling from off the jump, "Hey, Hiro-san, look over here," and you look this way, and you fall off the jump. In a sense, that's the situation with the monetary policy right now in Japan. If monetary policy goes astray, it's going to be sending off a signal distracting the government from carrying through on the policies they'll get at maximum lift. In other words, I want to get rid of some of the myths about how there's a spike in the Japanese government bond interest rate and the dangers of inflation, which I think are being exaggerated. I worry that misapplication of these myths and insufficiently aggressive response by the Bank of Japan could be the one thing that could throw the Japanese recovery off course. So let me talk about that for a moment.

Now, it's important to recognize a couple of things. The first is we actually know quite a bit about how inflation works and what independent central banks do. In fact, I'm one of the

people who have written on that, and basically, the way the world works is there are three categories of what monetary policy can do. There's a category when you have high inflation, in which monetary policy is essentially a slave to political weakness, and there's nothing monetary policy can do until there's a political consensus to stop it. This is Brazil and Argentina in the 1980s, Germany in the 1920s, and Japan in the 1930s, and it relates to when you have a breakdown of political authority and accountability. People just print money to solve their problems.

The second thing central banks cope with is low to moderate rates of inflation, meaning anything below 20 percent a year. What's interesting about this is that we all focus on this a great deal in the advanced economies at the moment, but it turns out to be relatively straightforward. Actually, inflation is inertial. It's very slow moving. Once you're down below even 15 percent, let alone down near 4 or 5 percent, if you make an error one way or the other, it doesn't tend to spiral quickly out of control. And we see this repeatedly in the European experience. Leaving aside whether it was good or bad, the master criteria were used to drag down the average inflation rate in Europe. The fact is if you look at it econometrically, or if you just think about the experience of Belgium or Italy or Spain, inflation doesn't tend to explode.

The third situation you worry about when you're in monetary policy is deflation. That is to say an actual decline in the level of prices. Deflation is really, really bad. Let me repeat. Deflation is really, really bad. The problem with deflation is twofold. It has direct negative effects on consumption. It puts fear into people. It makes them hold on to cash rather than useful assets. It makes them sit on their money, unwilling to spend it, because it looks like cash is their best bet, and they might as well just hold off. It also is really, really bad because it undermines your financial system. It rapidly escalates the burden for debtors and the uncertainty for people who hold debt.

Now, why am I bothering with this general typology? It's to point out two things. First, there is essentially no danger of Japan, whatever fiscal policy the government undertakes at this moment, getting into any sort of hyperinflationary situation, and I'll explain that in a moment. When I read the rhetoric published in the Japanese newspapers, including some stuff that was incorrectly published under my own name, there seems to be this belief out there that inflation, if you touch it, will immediately spiral out of control. And this seems to be a check on how aggressive the Bank of Japan is being and how much faith people have in government policy. And I want to argue that this is wrong.

The second reason I bring this up is to talk about how one gets from deflation to low inflation, and to stress that while it takes some doing, it's not as complicated as some people would think. There are very practical ways of managing that process. So let me expand on those two points.

Why am I worried about slaying the dragon of inflation obsession? When I was in Japan on a trip sponsored by Keizai Koho Center and led by Arthur Alexander of JEI, all anybody wanted to talk about was the spike in Japanese government bond rates. There was a confluence of events. Moody's, in its infinite lack of wisdom, decided to downgrade Japanese government debt. The trust fund bureaus' regular announcements were taken out of context, and weird things were done with them by the Budget Bureau of the Ministry of Finance to indicate that they were not going to be buying government bonds anymore. And the Bank of Japan got into a somewhat public discussion with the cabinet secretary and other government officials over whether or not they should buy Japanese government bonds directly.

What all this fuss and hullabaloo led to was a panic in the Japanese government bond market, and there was a fear, on my part, that this panic would offset the very good things that were being done on the fiscal and financial side, not just directly through interest rates rising. I think, in the end, that's not that important because the direct effects on bank capital and bank cleanup and direct effects on growth expectations from fiscal stimulus will be much bigger on investment than any small change in interest rates—just as we saw interest rates drop by five percentage points in nominal terms the last few years and have no effect on investment. But because it seemed like an erosion of confidence, it seemed like a way of saying, "Gee, the Bank of Japan does not support the government's policies," or "The Bank of Japan and the markets are giving a negative verdict on the government's policies," which is economically unjustified.

Now, why am I so sanguine about inflation in Japan? The basic idea is that you can only get burnt touching a stove if the stove is on. You can only start getting a cycle of inflation if there are actual pressures in the economy, and in a world where, as Mr. Kobayashi and other people have correctly said, there's going to be a certain amount of structural adjustment, improvements, cuts in retail prices, and unemployment, it's very hard to see how prices and wages are going to get bid up repeatedly.

So then trots out the myth, "Oh, well, but if the Bank of Japan goes away, if the Bank of Japan buys government bonds directly, there'll be no discipline on the government." Well, as some of you know, I have argued that the problem of Japanese fiscal policy in the 1990s has not been a lack of discipline. It's been too much discipline. In other words, austerity. There are a number of institutional biases in the Japanese macroeconomic system, both ideological and structural, in the form of a limited welfare state, that predispose the Japanese government to not spending very much in fiscal policy. I am very glad that the Obuchi government in the FY 1999 budget, for the first time since September 1995, is doing a real stimulus package, but there is no reason, political or economic, to think that this year's 3 percent stimulus will be followed by any such further supplementary measures in the years ahead. It would, in fact, be political suicide for the LDP.

So then you get the question, "But what happens if people lose faith in the government? What happens if there's so much debt?" Certain people I won't name tell you that there is Railroad Society debt and pension debt, and the society is aging, and half the golf courses aren't fully paid for yet, and on and on. Well, this is fine. This is something about redistributing money within Japan, but it can't be a real threat if there's no creditor coming to the door. And in Japan all the debt is domestically held. All the government debt is denominated in yen. This isn't even the United States in 1985. There is no foreigner sitting there with a couple of percent of GDP who can come knocking or dumping the currency. So there's no threat to the Bank of Japan to accommodate the printing of enough money to keep interest rates down so as to make the best possible effect of the policies that are already in place. Just simple, straight economics. It's not a realistic threat.

In my last couple of minutes, let me turn to how realistically monetary policy should run—and again, I'm trying to be narrow here, because I know my distinguished copanelists have their own special points they're trying to make—but I'm happy to give them an appropriate question to put this in a broader context.

How best should the Japanese government, should the Bank of Japan, which is indeed independent, tackle the problem of creating inflation in Japan? How much? What's the way to do it? I'll flack a second book. I coauthored, with a couple of academics, a book called *Inflation Targeting*, published by Princeton University Press. Unfortunately, it was written while I was at

the Fed, so however expensive it is, the Fed gets the royalties. The point is a number of major economies around the world, including the UK and Canada, have adopted public announced goals for inflation, and even central banks that are known for being something else, really have inflation targets. If you look at the Bundesbank or the Swiss National Bank, every year, along with their monetary target, they announce a public inflation target. That's their goal, and in fact, the European Central Bank, right now, is discussing how they're going to balance a monetary target versus inflation target.

Now, what's the magic of an inflation target? The magic is there is no magic. The magic is it's the grown-up way to do it. Here's how you do it: A central bank, no matter what happens to the financial system, no matter what people's expectations in the economy are, can always effect the price. A central bank can always print money and buy stuff, and if enough money shoots around the economy, it drives down the value of the currency some, which drives up inflation, and it lets people spend more money on stuff, which also pushes up inflation. This doesn't necessarily help the real economy, meaning growth and investment, directly. You need a functioning banking system to do that, and in Japan, for all the reforms, we don't have that yet. This is why monetary policy isn't going to save the economy alone. The issue is it's not to push on the ski jump, it's that we're trying to keep it from being a distraction—but you can always print money.

It really doesn't matter what you buy in terms of inflation. You can say, "Wow. There are a lot of Van Gogh paintings that people paid excessive amounts for in the 1980s. We'd like those to be in national museums or maybe in empty schoolhouses in Hokkaido. So let's print 80 million yen and buy those." Generally, however, you buy government debt, because the idea is it has no credit risk, and central banks don't like credit risk for good reason. Okay. So that's straightforward. The way you do it is you print money. You buy government debt.

Then comes the question: How do you know how much to buy? Well, usually, when things are normal, you have what's called a monetary demand function. You estimate over time. It doesn't tend to be very stable, but you have some clue that if you move money this much, you get this much inflation. In Japan at the moment, that's clearly not going to be a very dependable relationship. People are shifting in and out of various types of assets. People are scared. You're not going to be able to predict ahead of time exactly how much money you need, but you do know you need more than you currently have, because the CPI, the Wholesale Price Index, and all the price indices are negative. So you make more, and remember something I said earlier, inflation isn't explosive. There is no danger to just keep printing money until you get enough inflation. So how much is enough? Well, it's very clear that zero is bad, because zero really is negative for various measurement reasons, and it's very clear you want people, in general, to have no uncertainty that the price level is rising. So you want to have a little bit of distance from uncertainty, a little bit of distance from zero. So the number that practically every country that has an inflation target picks is somewhere between two and three percent. There's no reason Japan should be any different.

Final thing, why do you bother announcing it? Here's where the target idea comes in. You know you want to fight deflation. You know you want to pump up the money supply. Part of the reason you want to do this is to minimize people's uncertainty and sense of fear in the economy. So you can do it by surreptitious means. You can do it by the Bank of Japan buying in secondary markets and not telling people how much inflation it's going for. That seems to be counterproductive. You can do it by having a monetary target, except the monetary target doesn't really have any meaning, because you can always meet the monetary target, if you want,

at least on the narrow aggregate, and you only know the monetary target is good when you achieve the inflation rate you want. This is why, in the context of the ECB, I've called monetary targeting a monetary masquerade.

So just by the simple, commonsense process of elimination, it's better to tell the public what you're trying to do. "Gee, we're going to try to have an inflation rate of 2 percent or 3 percent over the next two years, and we're going to try to get there, and if we're not getting there, we're going to print more money. That's how you know, and if we're getting there too much, you can hold us down."

Well, it's fun to talk monetary economics, at least for me; I don't know for you. But let's bring it back again to the ski jump just in closing. The Japanese economy has been suffering untold damage. This is simply the most costly recession of any wealthy economy in the post-war period by a wide margin. The problems of structural reform need to be addressed. They are not the current problem. The current problem is getting the policies in line to get the Japanese economy back on a growth track. Surprisingly, pleasantly, happily, the Obuchi government has taken the two major steps. They have put in place a financial cleanup with an independent financial supervision agency. They have injected capital in the banks on a conditional basis, or they're in the process of doing it, and they're finally doing a fiscal stimulus that's large enough to make a difference. And it is, in large part, tax cuts, which means it will not get caught up in implementation delays. These two together, if they truly carry them out—and don't get me wrong, there are still ways they could be undercut—but if they truly carry them out, should be enough, as long as monetary policy doesn't see the dip and say, "Hey, why are you going down before you take off?"

Let's get an inflation target in Japan. Let's let the BOJ shed the unnecessary fears, and we will make sure that happens.

Japan's Macroeconomic Problems

Soichi Shinohara
Professor of Economics, Doshisha University

There is a saying in English, "First comer, takes all," and Dr. Posen takes almost all, so I don't have too much to say about monetary policy. Rather, I want to concentrate on the fiscal policy arena.

First of all, I have to say that I am quite optimistic about the longer-term structural adjustments of the Japanese economy, because we are observing many positive developments in various areas, as Mr. Kobayashi pointed out. But in the short term, I am quite pessimistic about the macroeconomic situation. Everybody, including the Japanese, American, and Asian people, think the Obuchi administration is doing something, but we have to be very careful about what government can and cannot do. Probably my talk today will be too pessimistic, but I want you to understand what the government cannot do.

Now, I'm quite pessimistic over the macroeconomic situation for two reasons. Everybody is stressing the shortage of aggregate demand in Japan—and the Obuchi administration is aiming to increase aggregate demand by pushing fiscal stimuli—but the problem is not the shortage of aggregate demand but the overcapacity of production, as well as the mismatch of the production structure and the demand structure. That's a more serious problem for getting the Japanese economy back on a growth trend.

Let me comment on the short-term macroeconomic outlook. First of all, the Obuchi administration has made a commitment to achieve a positive growth rate for fiscal 1999; unfortunately, most private forecasters disagree with the government's forecast. The average growth rate estimate by 32 blue chips firms in December last year was minus 0.5 percent. I think Mr. Kobayashi mentioned that figure in his speech.

Let me give one example of the macro focus. NIKKEI News prepared this (Table 1). I won't go into detail, but please pay special attention to the figures on fixed investment. This indicates the rate of change from previous periods. Fixed business investment in the private sector is forecast to be -5.4 percent, -5.4 percent, and -3.9 percent in the first three quarters of FY 1999, respectively. For the whole year, they expect that business investment is going down rather than up. Everybody is worrying so much about a slowdown in consumption, but the consumption figures are not so bad. The real problem is fixed investment. Note the forecast for pre-tax profits for the business sector. (This is, once again, the rate of change.) This is a very, very rough scenario for making a negative investment in macro, and my understanding is strongly supported by the recent Bank of Japan survey of the short-term business outlook. Sixty to 65 businesses out of 100 say that they have overcapacity in production. So this estimate coincides with the Bank of Japan's survey. That means we cannot expect a robust increase in investment in the next year or so. And, it has two serious implications for the macro situation in Japan. One is that the slowing of business investment means slower growth in Japanese productivity in the near future. The second is that because of the shortage in aggregate demand at the macro level, Japan tends to have more external surpluses, which might invite unnecessary trade frictions with the United States and other countries. Also, it may have a negative impact on the recovery of other Asian economies. So in the short term, the real problem is the shortage of business investment, and that's the first message I want to convey today.

Table 1
Macro Forecast - FY 1999

	1998			1999				2000
	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1
Growth rate	-1.7	-3.3	-2.3	-2.2	-1.2	0.0	-1.4	0.6
Consumption	-0.1	-0.3	0.3	0.1	0.3	0.0	0.4	0.7
Residential investment	2.1	-6.2	-4.2	-0.4	1.8	0.5	2.5	0.6
Fixed investment	-4.8	-4.6	-2.8	-5.4	-5.4	-3.9	0.0	-0.1
Gov't consumption	0.2	0.9	-0.7	0.3	0.2	0.3	-0.2	0.1
Gov't fixed investment	-3.0	3.6	9.2	-0.6	10.5	8.9	-17.0	7.3
Export	-2.0	1.6	-1.3	-1.3	-1.0	0.9	1.2	0.9
Import	-5.8	-0.4	-2.0	-0.9	-1.3	0.4	0.2	0.2
Business pre-tax profit	-35.8	-21.0	-38.8	-34.7	-20.4	-11.6	0.4	14.8
Unemployment rate	4.2	4.3	4.4	4.7	4.8	4.9	5.0	5.0

Now then, the second question is what does the Japanese government need to do for this situation? As Professor Posen pointed out, the Obuchi administration decided to introduce large-scale emergency economic packages in November 1998. But, the Japanese government made these kinds of efforts repeatedly after the burst of the bubble economy. The first one came in April 1993. The amount of that package was 10.7 trillion Japanese yen. Please note that the size of the Japanese economy is now 500 trillion yen. That was followed by 13.2 trillion yen in September of the same year, and it continued to the seventh big economic stimulus package, which was decided last year. The total amount of the seven stimulus packages is over 100 trillion yen. That's over 20 percent of the annual GDP of the Japanese economy. So on the surface, it seems to be very big, but still the stimulus effort didn't work. So we have to find out why it didn't work, and then we have to think about what to do.

Now, the third point that I want to make is how much demand can be expected to increase as a result of fiscal stimulus or some other measures. For that, we have to measure the precise number of the GDP gap. The GDP gap is the difference between production capacity and aggregate demand. Depending upon how it is measured, of course, the value changes slightly, but it is agreed that on average we now have a gap of about 10 percent of GDP. GDP is 500 trillion yen, and so 10 percent is 50 trillion Japanese yen. This is the amount of the shortage of production capacity.

Going back to the seven fiscal stimulus packages that the government undertook in the past few years: the total amount is over 100 trillion yen, but on average each package was only 15 trillion yen. Fifteen trillion was not enough to increase aggregate demand by 50 trillion yen every year. That's the first reason why fiscal policy didn't work. The size is too small. Even though the fiscal stimulus is not so big, if the multiplier is very large, then the fiscal stimulus might be able to work, but unfortunately the answer is, once again, no. Table 2 gives the value

of the multiplier, as estimated by the economic planning agencies last year. The value of the multiplier is 1.21 for fiscal investment development now in Japan.

As Table 2 indicates, the individual income tax cut is a miserable 0.4 percent. The U.S. government made a big mistake in the last one or two years by pushing the Japanese government to introduce a permanent income tax cut. We did it, but the result was an increase in savings, rather than an increase in investment. Then, as these data show, less than 50 percent of the income tax cut goes to stimulating aggregate demand. So, the average of the fiscal stimuli, including income tax cuts, is 15 trillion yen, and then the multiplier is on average probably about one. This shows that we have very serious difficulties from an empirical point of view, but theoretically we have the reason why fiscal policy didn't work in Japan. There are many theoretical reasons, but I want to pick up on just two today.

One is that the efficacy of Keynesian demand management policy should be marginal, not large in scale. In other words, in order for the government's fiscal stimulus to have a sizable impact, private spending, consumption, and investment must follow the increase in government spending or income tax cuts. Otherwise, the government must repeat the increase in government spending year after year. That's impossible. So private spending follow-up is quite important for insuring the efficacy of Keynesian policy. That condition does not hold for the Japanese economy now, because of the shrinkage in both the investment and consumption mindset. So we cannot expect much of a follow-up increase in private spending after the government stimuli.

Second is the concept of full-employment surplus. This is related to the budget deficit programs. I personally do not believe that budget deficits matter very much for the macroeconomic program, but somehow the market doesn't see it that way. It worries about an increase in the budget deficit and this sort of scenario: The government increases spending when the economy is in recession, and then the national income rises. Then, it introduces an increase in tax revenues. And, once full employment is reached, if the tax structure guarantees an increase in the budget surplus, on average, over the years the budget is balanced. But, once again, the tax structure of the Japanese economy does not guarantee that condition now. One economic indicator that shows this is the low value of the elasticity of tax revenues with respect to economic growth. Now, if economic growth increases by 1 percent, Japanese tax revenue will increase by less than 1.1 percent. So even though the government puts enormous amounts of fiscal stimulus into the economy, economic growth will increase only slightly. As a result, we can expect a very slight increase in tax revenues. That means we are moving toward an endless increase in government budget deficits. Please pay attention to the current value of outstanding public debt as a percentage of GDP. It's already 100 percent. Do you think that the market will allow the Japanese government to increase that ratio forever without limit? It's impossible. We have to stop the budget deficit now.

For those two reasons, it's quite difficult to expect a further increase in government spending or in the efficacy of government policies. Returning to Table 1, the short-term, macro forecast indicates a -1.2 percent growth rate. So probably we have to admit that the Japanese economy will continue in recession at least for another one or two years.

Now, that is fiscal policy. I have a slightly different opinion about the efficacy of monetary policy from Dr. Posen, but I have no time to discuss that today. It's quite difficult for the Bank of Japan to stimulate private investment whatever the measures, but I believe the more serious problem is the overcapacity in production as well as the mismatch of the supply structure and the demand structure.

Table 2
Multiplier

	Gov't Fixed Investment	Individual Income Tax Cut
1st year	1.21	0.41
2nd year	1.31	0.57
3rd year	1.24	0.22

Please consider, once again, the definition of GDP. That's the difference between production capacity and aggregate demand, and as I told you, it's quite difficult for the Japanese government to increase aggregate demand by 50 trillion yen per year. And, in order to solve the problem, we have to rely on the supply side—there is no very good theory for that. Everybody is saying that we have overcapacity, but by how much? It's quite difficult to measure it, but I have some data that might give you some intuitive understanding as to why the program is so serious.

Figure 1 illustrates the ratio of bank loans outstanding to GDP. Now, please look at the year from 1970 to 1981. The ratio remains at about 70 percent. So bank loans outstanding out of GDP is about 70 percent for 1970s, and then we see high growth in the 1980s, and then we get into a medium-growth period beginning in 1989. As a result, demand for financial funds for financing investment was declining. Then, again, the ratio was constant, and then after that, the direct financial market was developing in Japan. So for the major, large corporations, it became possible to finance investment directly through the markets by issuing corporate bonds and so on.

Now, the real problem starts around 1993. After the economic growth was over, money lending by the financial institutions kept increasing. The credit crunch of the last few years came down, but still the ratio was 100 percent. This is equivalent to the ratio of outstanding financial institutions' loans to the GDP of China, but China doesn't have a very developed financial market. Still, this ratio was the same for Japan. What does it mean? We probably lent too much to business. So, we should speculate that the banks made too many loans to businesses that did not have solid profitability prospects. This is very, a very serious figure. Even though everybody is stressing the financial problems in Japan, they are not only the problem in the financial sectors. There is also the problem of overlending to the business sector. So, the financial problem is also a problem of restructuring the manufacturing and service sectors.

Let me give you one small example, once again, to stress the hypothesis. A recent survey by the gasoline station industry indicates that one out of every three stations is considering closing. If we ask Japanese friends, "Are you going to have any problems getting gasoline on the road if one out of three gasoline stations closes?" everybody says, "Probably no. We will have no problem." What does it mean? Probably we have too many gasoline stations that the people don't need. Then, the answer for that is government protection and government regulation.

Now the market became very free and competitive about two years ago. Then, suddenly, one out of three find problems in their programs, which was supported by the banking sector. So we are getting into the real serious problem of the restructuring of the industry.

I am talking too much in pessimistic terms, but actually industrial structural adjustment has already started in many areas. One example is the gasoline stations. Of course, unemployment is the very high cost of adjustment. We have to think about some infrastructures to absorb the costs of adjustment. In that sense, I am not so pessimistic, but at least for the short term that type of adjustment will not allow the Japanese economy to go back to a 2 percent growth rate.

Problems with Japan's Economic Policy Process

Hugh Patrick
Director, Center on Japanese Economy and Business, Columbia University

Let me make several general points before turning to my assignment, which is to talk about the problems of policymaking in Japan.

It seemed to me that Tim Geithner's message today on U.S.-Japan relations had two central themes. The first theme was that the only thing worse than a strong Japan is a weak Japan. That is to say, the only thing worse for the world and for the United States than a rapidly growing Japan is a Japan that's not growing at all. Second, what I took away from his remarks, is that the attitude persists in this administration and in the Congress that it's very convenient to have Japan as a potential scapegoat to attack when things aren't going well, and that how strongly Japan is attacked as a scapegoat depends on how difficult our domestic economic situation is. So that as soon as we go into a growth slowdown and start to have increases in unemployment, we're likely to criticize Japan much more severely than we do today. Frankly, I don't think that is a very good model for handling relations with a major ally.

The major, and I think probably the most important, structural problem that Japan has had is this deficit of demand, the demand gap. This deficiency really has been a structural problem that began in the mid-1970s, and in some sense, it's the essential Keynesian problem of a country that saves more than private investment demand uses effectively. Over the past 25 years, Japan has done the traditional things of investment. First, huge expansion in government spending from 1975 to 1980, and then a huge expansion of the current account surplus, and then slow growth in the 1990s—a combination of adjustments. But this savings investment gap or deficient demand gap is something that is likely to persist for some time.

Now, if Japan were a small country—if it were Singapore or Taiwan—it could rather easily solve this by running a current account surplus, exporting its savings to the rest of the world. The dilemma is that Japan is much too large an economy for the United States and Europe to accept that degree of industrial structural adjustment. Suppose Japan ran a current account surplus of 6 percent of GNP or 8 percent of GNP, as the UK did in the nineteenth century. That would solve their problem. It would make savings available to the rest of the world. It would be wonderful on paper, but it would imply that the many key industries in the United States and Europe—auto and steel, for example—would be under tremendous pressure from a yen that was 180 to the dollar, something of that sort. The international system would be under pressure from the currency realignment that would come out through that. And, politically, it's impossible for any large country, including Japan, the United States, or those in Europe, to export its way out of a recession. So that's a dilemma Japan faces.

One further general point: I think we've been talking about change and the need for change. You might argue that in some sense the people who are 50 and over in Japan are a very unusual generation and atypical. Essentially, they grew up in the period of early post-war poverty and structural adjustment, and the most important thing was job security, and this generation, basically, I would say, is very risk averse. They prefer to hold their savings in low-yield, low-risk savings deposits and so forth.

Even so, it's interesting that the people who manage the companies, when they saw growth opportunities, invested like mad. But, basically, that risk-averse generation will be moving from the scene, and those who are under 30, I would say, are much more prone to risk

taking, because they grew up in affluence. They don't know what risk is, and therefore they are willing to be more adventurous, willing to change jobs, willing to seek new ways of expressing themselves, and that, I think, is a wonderful thing. There are young politicians, businessmen, and people in all fields who are perhaps going to go back to the dynamism that existed in Meiji or Taisho or something of that sort. So as much as I think of your generation, Yotaro, you're an aberration, and it's a very fortunate thing. So that is a positive in the long run.

Let me turn to problems in economic policymaking. It certainly is true that we have seen a decline in the influence of the traditional triangle of a very elite bureaucracy that provided information and ideas to the political leadership, particularly in the Liberal Democratic Party, that supported the pro-business policies that big business wanted. We've seen that break down. It's not broken down. It's simply weakened. The bureaucracy has been weakened over time, because of loss of credibility, particularly, the Ministry of Finance, the one that has the most economic power. Moreover, politicians are under tremendous pressure to change. In that sense, I think that last summer's Upper House elections were a real watershed because they made very clear that the voters wanted a government that would end the recession, bring about economic recovery, clean up the banking mess, and get on with it. I think that message was so loud and clear that it made it possible for the Obuchi government to come in and take very forceful action. They did fiscal stimulus that was in the hundreds of billions of dollars. They have put up $500 billion for banking reform. These are really major steps, but still, there's a structural dilemma that the politicians do not have staffs that are large enough to be able to do much of the way in independent policy analysis. So they're caught in a dilemma of trying to get ideas, not only from the traditional bureaucracy but also directly from businessmen. And how that's working, I think, is still very unclear, but perhaps it's a prospect for the better.

Over time, of course, one of the dilemmas in policymaking in Japan is that each of the ministries has its own entrenched attitudes and parochial definition of the national interest. The Ministry of Agriculture's definition of the national interest is to protect farmers, and clearly that is not desirable in the long run. The Ministry of Construction's is to protect the construction industry, to perpetuate the Dango system and make sure the politicians get funded and so forth. The Ministry of Finance, as was pointed out, has a very strong deflationary bias. It has a Tax Bureau that never wants to cut taxes and a Budget Bureau that never wants to increase expenditures, and you don't have offsetting within the ministry a strong force that understands the importance of expansionary fiscal policy. And so that's been a terrible problem, I think, on the policymaking side.

Underlying all of the discussion, I think, there has been the tremendous fear of substantial increases in unemployment because of the weak social safety net that exists at the present time and the fear of all politicians that if unemployment goes up dramatically they will get voted out of office. And there's a lot of talk about the rigidity of Japanese labor markets. But, as Arthur Alexander and others have pointed out, in fact, if you look at industry-level adjustments, the United States and Japan adjust just about the same way in terms of shifting of labor and changes in production output of different sectors. The Japanese labor market is pretty flexible. Most of the people work in smaller firms, and there's greater flexibility there. Even in the large blue-chip production firms, we've noticed over time very substantial adjustments in the blue-collar labor employment. If you take the steel industry, for instance, over time the Japanese steel industry has reduced its blue-collar workers very substantially.

The problem, I would argue, is not really a macro problem of adjustment, but a micro problem of middle management adjustment. The companies feel an obligation to these little

managers who are in large surplus because the companies hired them 20 years ago in expectation that the companies would continue to grow rapidly, and there's a disproportionate amount of attention paid to them because they are us, right? They are the same people that we are. They went to the same universities. The journalists are friends with these guys. They write stories about how hard it is for them, etc. But in a macro sense, it's a relatively small proportion of the total labor force. Psychologically, it's the same sort of effect that we had in the United States when IBM and AT&T suddenly started to downsize middle managers, and the psychological effect that somehow white-collar workers also had job insecurity was a shock in this economy. Fortunately, our market for labor meant that those people somehow were able to start consultancies and new jobs, and I think the key issue in a labor-adjustment sense is how to find decent jobs for middle managers that should be redundant from large firms. In that sense, I think the fact that there are lots of medium-sized, smaller family-owned Japanese firms that are very poorly managed is an opportunity for them to bring in talented professionals if they have the willingness to do that.

Finally, let me turn back to some of the macro points that were made. I agree very much with Adam Posen that the inflation threat in Japan is greatly exaggerated and that the fear of running budget deficits in the long run is also greatly exaggerated. In the future, if those inflationary pressures develop, they will develop because the demand gap has been eliminated, and that's the most important thing to do right now. You're so far from eliminating that 10 percent, according to Mr. Shinohara—whatever the number is, it's huge—and to worry about inflation in those contexts, seems to me, really quite ridiculous. Indeed, it is a constraint on the thinking of the business community and the government alike, and I hope I can educate Mr. Kobayashi to change his thinking a bit on this issue. It's much less of a problem.

It's true, this phrase "inflation targeting" is a very good academic phrase, but it's a terrible PR phrase. I don't know how you guys let yourselves get sucked into that term. We're not talking about inflation. We're talking about a sort of natural lubricant in the economy of 2 to 3 percent CPI, which keeps things going smoothly. We all know that zero price increase is a constipating effect on the economy. So you want a lubricant, and 2, 3 percent is not inflation. It's just sort of normal life, and to call it "targeting" is bad, and to call it "inflation" is bad. So find better terminology but do the substance.

Finally, we talked about policy perspectives of Japan, short term, medium term, and long term, and it is really timing in terms of the macro phenomenon. In the short term, the most important thing is to get sufficient demand into the economy through fiscal and monetary policy and structural adjustment, which is a longer-run process, in order to bring about economic recovery and have the economy growing. Only after the economy is growing, and to do that, you have to continue fiscal stimulus and deficit. Then, the second target is not the budget. The second target is to get interest rates back up to a normal level. Japanese interest rates are crazily low, and they are so low that pensions can't be funded. So you've got to get them back up to a decent funding level. They're so low that the usual pricing signal of the cost of capital doesn't work adequately in the corporate sector. They're so low that savers who get 0.3 percent on a one-year deposit sort of feel that they're getting screwed, and they're going to look for alternative assets, and some of that could be foreign. In the long run, I don't think that's necessarily good for Japan. So that's the second target.

Then the medium term, is, as the economy recovers, get interest rates back up to 3, 4, 5 percent, whatever the sort of international levels in Japan's history were. Then, once that's done, you start to worry about reducing the budget deficit, and with sustained growth, you can do that.

One of my objections to Mr. Shinohara's analysis, which is based on the Economic Planning Agency estimates of the tax elasticity and elasticity of government spending, is that it is based on data of the 1990s, which is an aberrant period. As we return to more normal and steady growth, and people think that growth is going to change, the savings rate of households will gradually continue to decline. The little upward blip will end, and consumption will pick up, but that will take time, and, typically, we find that consumption only picks up after business investment picks up. So that's a real dilemma that he's pointing out.

Now, one of the advantages of having a certain amount of inflation, 2 to 3 percent, is that it sends a different signal to consumers, and the message is, "Now is the time to buy that condo I was thinking of buying but waiting 'til the price went down even further, or the car and so forth that I was going to eventually replace because prices are going to go up from now on." So you might get a pickup if it became a widespread perception that the prices were not going to continue to drop, but had bottomed out and were going to rise slightly.

Let me end with one final sort of question. It's really to Mr. Kobayashi. Can the Obuchi government afford negative growth for fiscal 1999 or will it feel that it has to do something? You repeated what is, I think, a common business view that somehow further fiscal stimulus isn't necessary or won't work, though you did note the possibility of a tax cut. I think that if the business community and the government are thinking that way, they're precluding a policy option that they should still keep open, which is if the economy doesn't pick up this summer and fall, they may have to have an additional fiscal stimulus. Possibly, it would be through a temporary tax cut like a reduction in the consumption tax. I'd like to hear from you at some point how you view that.

Closing Speech

Stuart Eizenstat
Undersecretary of State for Economic, Business, and Agricultural Affairs

Thank you very much. I have a great affection for this institution, CSIS, and for its Japan chair. I am very pleased to have the opportunity to speak to you. About 20 years ago, with Mike Mansfield at the helm, our embassy in Tokyo came to be known as the "Bar None Ranch." That was due, of course, to the phrase that Ambassador Mansfield coined when he came into the job: that the U.S.-Japan relationship is the most important bilateral relationship in the world, bar none. Though my foreign experience abroad was as U.S. ambassador to the European Union, I can confirm the validity of Mike Mansfield's statement. I remember visiting him when I was between government positions and the private sector. I came at 9:00 in the morning for a courtesy call because I had known him when I was President Carter's chief domestic adviser and he was then the Senate majority leader. He must have already been then in his late 70s, greeting me with his sleeves rolled up. And exactly at 9:30, half an hour after, he said, "OK, it's time for my next appointment." He was all business, but he was a great advocate of U.S.-Japan relations.

Looking at Mike's tour, I can confirm that one thing never changes and that is that in our strong, deep, and multifaceted relationship, it's trade and economic problems that seem to get the attention. Of course, this is an economic conference, but I want to begin by putting our relationship into a broader context, mentioning the strength of our overall U.S.-Japan relationship and the key role Japan plays in insuring stability in East Asia. Japan is home to 47,000 of our 100,000 troops in Asia. Japan provides about $5 billion annually in host nation support. That's ten times what our European allies contribute to support U.S. bases in Europe. Japan is home to the U.S. Seventh Fleet, which includes a carrier battle group, the Fifth Air Force and the Third Marine Expeditionary Force. Later this spring, the Diet is expected to pass implementing legislation for the U.S.-Japan Defense Guidelines, which will provide a framework for closer cooperation on defense particularly should contingencies arise. The threat from North Korea has led to increased communication and cooperation. As a founding member of the Korean Peninsula Energy Development Organization (KEDO), Japan's efforts have been key to maintaining the freeze on North Korea's nuclear weapons program. We consult and work together on developments in China, Russia, South Asia, the Middle East, and other trouble spots.

I personally worked very closely with Japanese officials in my capacity as head of the delegation of the United States to the Kyoto Climate Change Conference, and were it not for the close U.S.-Japanese cooperation, we could not have had the Kyoto Protocol. And that cooperation continued in Buenos Aires a few months ago. We work together on other global issues as well through the Common Agenda, chaired by my colleague Frank Loy. It is one of the best-kept secrets in Washington, but it has a great impact on fields like basic science research, environmental protection, and overseas developmental assistance. The scope is large—there are more than 200 projects with activities on almost every continent that we do together. Just a few examples:

- In Central America and the Caribbean, Japan and the United States are working together to protect natural reserves through the Parks in Peril Program;
- We are jointly combating infectious diseases in Africa, Asia, and Latin America; and
- We are conducting research to protect coral reefs and improve our ability to predict global climate change patterns.

Undersecretary Loy will chair the Common Agenda Plenary on April 8 in Washington, and I hope that will help bring this well-kept secret to light and give it the attention it deserves.

I want to turn now to the theme of your conference and paraphrase Ambassador Mansfield: there is no issue more important to U.S.-Japan relations than the revitalization of the Japanese economy, bar none. The United States has a direct stake in an economically strong Japan because our prosperity, our security, and our work on global issues depend on it. Japan is one of our largest export markets, and for many important sectors, it is our largest export market, from farm products to aircraft to pharmaceuticals. Even in a weakened state, Japan's economy is 70 percent of Asia's total GDP. So, it is clear that the health of Japan is absolutely vital if we are to see an end to the Asian financial crisis, now in its seventh year. Although there are some promising prospects for positive growth in some of those countries—like Thailand and South Korea—by the end of the year, they will not achieve the levels of growth that they and all of us want to see unless and until Japan begins to recover and absorb some of their exports, rather than just the United States. Japan has played a central role in dealing with the crisis, committing some $50 billion in assistance through the IMF facilities to support trade and investment financing and direct aid. That said, however, the best medicine Japan can give an ailing Asian economy is a strong Japanese economic recovery. This brings me to discuss the U.S. agenda with Japan.

We are pursuing three avenues in our economic agenda. First, we are stressing to Japan that Japanese growth must come through strengthened domestic demand. We believe that fiscal stimulus, appropriate monetary policy, and the restoration of confidence in the banking system are a key to renewing consumer confidence and generating growth. Japan should not export its way out of its problems, and it should not see the U.S. market as its market of last resort for its excess production, which is in some cases unfairly traded. For example in the case of steel, we have told Japan that unless exports to the U.S. fall to pre-crisis levels, we will be prepared to take action under our trade law. We are encouraged by the recent decrease in shipments, but we need to see this trend continue. Since the summer, Japan has moved more aggressively on monetary action. Tokyo is now implementing two large supplemental stimulus packages, and the Diet recently passed an expansionary fiscal 1999 budget in record time. The Bank of Japan has steadily eased monetary policy to get credit flowing again. And the Japanese government appears to be coming to grips with the problems in the banking sector. We see a significant process now underway to infuse public money into the banks to work off the bad loans from bank balance sheets.

However, most analysts both inside and out of Japan, myself included, believe Tokyo cannot rely solely on fiscal and monetary measures to revive the economy, let alone to generate the productivity gains needed to provide for the world's most rapidly aging population. There are, frankly, mixed signals in terms of the Japanese economy. The official government estimate is for 0.5 percent growth by the end of this calendar year. At the same time, the stock market has seen a surge with swelling volumes, perhaps as a result of the beginning of real implementation of bank restructuring. And yet, the fourth quarter GDP statistics don't provide much encouragement in terms of starting this next quarter with any real momentum. The fourth quarter GDP statistics released on March 12 showed 0.8 percent decline. That's a 3.2 percent decline on an annualized basis—and that is worse than was predicted—and the calendar year GDP closed at minus 2.8 percent. The fourth quarter contraction was led by shrinking private domestic demand, down minus 1.2 percent. Investment indicators such as machinery and machine tool orders were also off sharply. So, again, we wait to see if bottom has been hit yet,

and no one can be sure. Consumer confidence is absolutely, seminally crucial in this respect.

The second avenue we are pursuing, therefore, is to impress upon Japan that in addition to fiscal and monetary measures, it also needs to deregulate and restructure its economy. Most of the market access problems we have taken up in the last twenty years with Japan are really issues of government regulation and competition policy. From foreign products to telecommunications equipment, from services to steel and glass, the Japanese government has for too long used regulation to protect inefficient and noncompetitive industries. My Japanese friends often tell me that they understand the need for deregulation but argue that it would be disruptive in an economic downturn. My answer is quite the contrary. And we can draw on our own U.S. experience in the last 20 years and my own personal experience when I was in the White House in the late 1970s and early 1980s. Short-term dislocation will quickly be overtaken by gains in competition, efficiency, and productivity from deregulation. That's what happened when we deregulated airlines, trucks, and so many other institutions in the Carter administration and then following in the Reagan years in telecommunications and other areas. The gains in employment in financial services, in aviation, in telecommunications, and in deregulated areas, are dramatic and free up all sorts of efficiencies and innovations in the economy. The same will happen in Japan. The United States has a large stake in how Japan's deregulation proceeds. Deregulation will produce growth, strengthening domestic demand generally, as well as for U.S. exports and the exports of suffering Asian neighbors. Regulations also can effectively bar imports and slow the introduction of new products and services in sectors in which U.S. firms are highly competitive. Competition is, in fact, the best way for the Japanese economy to restructure.

Two years ago, President Clinton and then Prime Minister Hashimoto announced the Enhanced Initiative on Deregulation and Competition Policy. That initiative provides for annual progress reports on dealing with issues of particular concern to U.S. business. The second annual report may come out as early as the end of this month and, as Prime Minister Obuchi's May visit approaches, we expect to be able to showcase in that report specific measures that will produce new opportunities for U.S. exporters and gains for Japanese consumers. Let me be specific. By way of example, let's look at telecommunications. Phone rates in Japan are by far the highest in the G-7 countries. These high prices severely limit the demand in Japan for the new kinds of information technologies that have become wildly popular here and elsewhere, for example, Internet connections. The result: total traffic on Japan's telecom network is only a third that of the United States on a per capita basis. In the United States, deregulation has brought continued sharp increases in new investment in telecommunications. But in Japan, remarkably, new investment in the telecommunications sector is actually falling. This is the sector of the future, and it is falling. Telecommunications is a core area of our Enhanced Deregulation Initiative. Bringing down telecom rates would stimulate domestic demand in Japan for new types of communications goods and services, and there would be new export opportunities for U.S. firms. Our request of Japan in this sector and in others in the Enhanced Initiative—including medical and pharmaceutical products, energy, distribution, housing, financial services and competition policy—are reasonable and appropriate. They are not just good for us; they are good for Japan.

The third avenue in our economic agenda is improving the environment for foreign direct investment in Japan. Through the U.S.-Japan Investment Working Group, the United States is focusing on problems that especially affect newcomers to the market, and that includes most U.S. and other foreign firms in the areas of mergers and acquisitions, land use cost, and labor mobility. This work is more important than ever for both countries. For corporate restructuring

to proceed, Japanese companies need a regulatory and tax regime that will allow them to spin off unprofitable activities and focus on core strengths. American companies, on the other hand, have an unprecedented opportunity to play a direct and significant role in Japan's economy through investment in top-flight firms. Cargill's purchase of one of Japan's largest food suppliers, Carrier's takeover of Toshiba's air conditioning unit, GE's purchase of Japan Leasing, Morgan's purchase of Yamaichi's brokerage outlets, are just a few of the recent examples of how Japan and the United States both benefit from foreign direct investment: higher employment, new investment capital, technology transfer.

The U.S. government is working hard to ensure our trade agreements are fully implemented and yield concrete results. There have been many success stories where once closed markets in Japan have opened, and U.S. and other foreign firms are now able to bring their globally competitive products to eager Japanese consumers. A notable example is in semiconductors, where foreign suppliers now account for roughly 35 percent of the Japanese market from under 15 percent in 1991. Easing the rules on large store openings has helped companies like Toys "R" Us, which will open its hundredth store in Japan next year. The historic aviation deal in 1998 has been a boon to air service between the United States and Japan, and we worked very closely on that, Al Larson and myself. (And Al deserves a great deal of credit for that, as do the other negotiators.) More flights are taking more passengers and cargo to more cities in Japan, and the result is significant revenue increases for our highly competitive airlines. In other areas, more work clearly needs to be done. Without attempting to be exhaustive, I have put into this category government computer procurement, reasonable access to network connection and telecom, the flat glass agreement, and insurance. In these and other sectors, the U.S. government will continue strong efforts to achieve fair market access. I am optimistic about Japan's economic future and the prospects for dealing effectively with issues on the economic agenda. Things change, sometimes even for the better. When Bob Zoellick was in the job I now hold, the U.S. talking point to Japan was economic growth through domestic demand. And Japan's talking point to us was "Well, you need to cut your federal deficit to be competitive." Here, President Clinton understood the problem we faced, and the administration and the Congress took tough political choices to get where we are now—and that is with surpluses ahead for the next several decades. Things may move a little more slowly in Japan, but I think that Japan understands the nature of the problem they are facing and are moving at last in the right direction.

When Prime Minister Obuchi visits Washington in early May, the U.S. government and business community will be deeply interested in what he will have to say on economic and trade issues and, in particular, on deregulation. I hope the prime minister will see his visit as an opportunity to defuse trade tensions by showcasing measures in these areas that will improve market access and lure more foreign direct investment as well as boosting economic growth. To make this summit more productive, we have just invited Japan to create with us a new subcabinet group chaired by the National Economic Council (NEC) on our side, which would include the State Department, Treasury, Commerce, USTR, and Department of Justice, to look at issues like the broad economic context of our relationship, deregulation and market access, the U.S.-Japan Investment Initiative and antitrust acts. I want to emphasize that this subcabinet group would be specifically for this summit, but it is a way of trying to broaden the engagement of our agencies and to expose our agencies to yours and your agencies to ours and to see to it that we have a more concrete and specific and less tension-ridden summit. Now, one could discuss each of these issues for a very long time, but I want to leave time for your questions and comments in the

few moments that I have left here. Thank you very much.

Q&A

Q: At the end of the year without more fiscal stimulus, there will be a new downturn. Do you share that concern? And secondly, has the priority shifted since the last summit to structural reform?

A: Those are two good questions. On the first one, I don't want to suggest that we think one way or the other that additional fiscal stimulus is going to be necessary in the middle of the year. I can tell you that in a meeting I just had today with a senior Japanese business leader, he indicated that he felt that that might be necessary. But it is not something on which there is a U.S. government position, and I want to emphasize that. With respect to the deregulation agenda, your second question, the answer is yes. This is taking a higher priority. The reason is that there is now substantial fiscal stimulus, a more expansionary monetary policy, and evidence that the large injection of funds into the banking sector, which the Japanese government had provided some months ago, may in fact be beginning to be effectively used. Obviously, we want to keep an eye on all of those issues, but as Tim and I said, those are all important, but they are not sufficient. I think that, in a more profound way, the Japanese model, which was a heavily protected domestic market with an export orientation, is one that has fundamental flaws in the 21st century global economy that we are facing. And, the way in which one can do more than simply put a bottom on the fall of the economy, which I think has been done, and stimulate real growth, is in fact to open the economy to foreign direct investment and to deregulate the economy and free up the natural competitive capacities of the Japanese people and businesses. After all, I have been to Japan many, many times. Japan has one of the best, most-educated, and most-productive work forces in the world. It has world-class companies and world-class reach and capability. So, one has to keep asking, "What's the problem?" You can go back to the bubble bursting, creating the loan overhang. You can talk about the tax increase of a couple of years ago when the economy was weak, which we argued strongly against. But there is something, we believe, more fundamental, and that is simply the lack of competition and openness in the economy. And I want to stress again that we are not just talking about this as a good opportunity for U.S. business, as important as that is. We are saying that for Japan to reach its economic potential in the 21st century, to be the leader in Asia, to help its neighbors out of the worst fiscal crisis in 50 years, it is essential that growth expand—and not at 0.5 percent. We believe that that will only occur with good fiscal and monetary policy, with banking reform, but with this additional element of deregulation and more competition and more foreign investment. There is evidence that this is beginning to happen. I don't want to suggest in any way that it isn't, that there is a complete stalling. There is a beginning, and I cited examples of the kind of foreign investment by the United States that would not have been available previously. I might also say that with prices in their current posture, it is an opportune time for those kinds of investments, and I think that is increasingly recognized by U.S. and foreign companies.

Q: Is it fair to say that the president is more concerned about the Japanese economy now than when he visited Japan in November? And secondly, if the forecasts for another year of negative growth in Japan are correct, how concerned are you about the implications for the rest of Asia and the rest of the world?

A: Well, first of all, I am not going to try to characterize the president's thinking. I learned

that a long time ago. What I would say is that anyone looking at the fourth quarter figures has to be concerned that the momentum one would have hoped for going into this year doesn't seem to be present. Now, things can change, and in fact, the rise in the stock market can have a number of positive impacts. It can have a psychological impact on the consumer, it can have a psychological impact on companies, and it can also have a real impact in terms of the valuation of companies. If property values begin to rise along with the stock market that would obviously help the banks. Obviously, we found in our own country that—I wouldn't say a rising market "lifts all boats," as John Kennedy said, but it lifts a lot of them—a rising stock market can be a real stimulant. It's always difficult to forecast. Economists obviously are good at looking back and not necessarily good at looking forward. But one has to be concerned when you see fourth quarter figures that are worse than anticipated. Just as when we had a better fourth quarter than anticipated, it gave us some confidence that we would go into 1999 with some real momentum. Japan does not have this momentum, so it is sort of starting from, at best, ground zero, and no one can tell if the bottom has been reached. There is some reason to believe that perhaps it has, but when the government itself, which has a reason to be more optimistic, is only forecasting 0.5 percent growth for the year, that obviously is not the kind of growth that Japan deserves. It is not the kind of growth that will lower unemployment. It is not the kind of growth that will help deal with the Asian financial crisis. And it is not the kind of growth that will relieve some of the pressure on our trade deficit.

Q: Could you comment on the yen-dollar exchange rate and the possible devaluation of the Chinese renminbi?

A: I am repeating all of the lessons I have learned for 30 years in this business. One is not to characterize what the president is saying, and the other is not to talk about exchange rates. Suffice it to say that it is important that China maintain its currency value and that we not get into a cycle of competitive devaluation. I would also remind you that China had a very large devaluation in 1994.

Q: How can foreign direct investment be promoted?

A: The most important thing that can happen to promote foreign investment is for the Japanese government to reduce the restrictions that limit investment in particular sectors. Let me go back and look at this foreign investment issue. Japan has one of the lowest ratios of foreign direct investment of any industrialized nation in the world. If you look back, not that long ago—10 years ago, 15 years ago—there were all these scare stories about Japan buying up America, Rockefeller Center and so forth. Those stories never got anywhere in this country. There were some blips, but they never really got anywhere because, at the same time some people were trying to whip up a public frenzy, 50 governors were out there trying to get more Japanese companies to invest in their states and taking trade missions to China and European countries. Americans realize that it doesn't particularly matter who pays your paycheck as long as it is a good paycheck, and you have a good job. So, we have become a remarkably open economy to foreign investment. I haven't noticed that the character of the United States has changed or that our culture has changed. The same people in France who don't like our culture still don't like our culture. And it has been a boon to the United States. It has created jobs and opportunity. The same thing will happen in Japan. You are not going to lose your distinctive Japanese culture. It is too embedded. What will happen is that you will have so many more job opportunities, and that will only happen because U.S. companies are willing and anxious to get

into the market. Again, I think the drop in values makes it a particularly opportune time for this. What has to happen, and it is beginning in some sectors, is that the restrictions that the government has imposed have to be lifted and phased out.

About the Speakers

Stuart E. Eizenstat
Undersecretary of State for Economic, Business, and Agricultural Affairs

On June 6, 1997, Mr. Eizenstat became undersecretary of state for economic, business, and agricultural affairs. His job includes advising the secretary on international economic policy and leading the work of the department on issues ranging from trade and aviation negotiations to bilateral relations with major partners such as Japan and the European Union. Mr. Eizenstat retains his title and responsibilities as special envoy for property claims in Central and Eastern Europe. From April 5, 1996 to June 6, 1997, Mr. Eizenstat was undersecretary of commerce for international trade. At Commerce, Undersecretary Eizenstat led the U.S. Department of Commerce's International Trade Administration. His responsibilities included, promoting U.S. exports, assisting American business efforts abroad, enforcing laws against unfair trade practices, and developing trade policy. Mr. Eizenstat served as the U.S. representative to the European Union. He concurrently served as adjunct lecturer at the John F. Kennedy School of Government at Harvard University and as a guest scholar at the Brookings Institution in Washington. From 1977 to 1981, Mr. Eizenstat served as President Carter's assistant for domestic affairs and policy and as executive director of the domestic policy staff at the White House. In 1976, he joined the Carter presidential campaign full time as director of issues and policy; after the election, he became the Carter-Mondale Transition Planning Group's director for policy, planning, and analysis. He is an honors graduate in political science of the University of North Carolina at Chapel Hill and received his law degree from Harvard University in 1967.

Timothy F. Geithner
Undersecretary of the Treasury for International Affairs

Timothy F. Geithner became undersecretary of the treasury for international affairs on December 14, 1998. As undersecretary, Mr. Geithner is responsible for advising the treasury secretary, and deputy secretary, on all aspects of international economic, financial, and monetary policy developments. Prior to this appointment, Mr. Geithner served as assistant secretary of the treasury for international affairs since September 1997. He previously served as the senior deputy assistant secretary for international affairs and the deputy assistant secretary for international monetary and financial policy. Mr. Geithner joined the U.S. Treasury in 1988 and served as special assistant to the undersecretary for international affairs and assistant financial attaché in Tokyo among other positions. From 1985 to 1988, he worked for Kissinger Associates, Inc. Mr. Geithner graduated from Dartmouth College with a B.A. in government and Asian studies and from the Johns Hopkins School for Advanced International Studies with an M.A. in international economics and East Asian studies.

Yotaro Kobayashi
Chairman and Co-Chief Executive Officer, Fuji Xerox Corporation

Mr. Kobayashi is one of Japan’s most well known and respected business leaders. He joined Fuji Photo Film Co., Ltd. in 1958 after receiving his B.A. in economics from Keio University

and his M.B.A. from the University of Pennsylvania Wharton School of Finance and Commerce. He was assigned to Fuji Xerox in 1963, becoming executive vice president in 1976, president and CEO in 1978, and chairman and CEO in 1992. Mr. Kobayashi helped build the company into one of Japan's most successful joint venture businesses. At the same time, he has been actively involved in a wide range of civic activities, with special emphasis on promoting U.S.-Japan relations and championing domestic administrative reform. Serving on numerous government, business, and academic councils, Mr. Kobayashi is currently Japanese chairman of the Trilateral Commission and vice chairman of the Japan Association of Corporate Executives (Keizai Doyukai), where he will be officially elected chairman in April 1999. Mr. Kobayashi was awarded the Medal with Blue Ribbon (Japan) in 1991, the Insignia of Commander First Class of the Royal Order of the Polar Star (Sweden) in 1995, and the Royal Norwegian Order of Merit (Norway) in 1997.

Hugh Patrick
Director, Center on Japanese Economy and Business at Columbia University

Professor Patrick specializes in the Japanese economy and its business systems, Pacific Basin economic relations, and U.S.-Japan economic relations. He has organized a number of research projects resulting in volumes on the Japanese banking system and financial markets; comparative analysis of the Japanese, Korean, and Taiwanese financial systems; industrial policy for troubled industries in nine Pacific Basin economies; and international trade policy and the structure of the Japanese economy. He chairs the Pacific Trade and Development Conference Series and is on the board of directors at the Japan Society. Professor Patrick received his B.A. from Yale University, and holds a Ph.D. from the University of Michigan.

Adam S. Posen
Research Fellow, Institute for International Economics (IIE)

Dr. Posen has a long-established interest and expertise in economic developments in Western Europe, particularly in Germany and in the United Kingdom, having worked there for the Federal Reserve. With his extensive research work, he is recognized as one of the world's leading experts on the practice of central banking and monetary policy, and he regularly publishes work on the monetary strategies of the G-7 countries including the Federal Reserve. He is also active in discussions of the international monetary system, including the likely course and implications of EMU, the appropriateness of fixed versus flexible exchange rate arrangements, and the institutional aspects of transparency and political accountability for macroeconomic policy. From 1994 to 1997 he was an economist at the International Research Foundation of the Federal Reserve Bank of New York. From 1993 to 1994, he was the Okun Memorial Fellow in Economic Studies at the Brookings Institution, and from 1992 to 1993 he was a Bosch Foundation Fellow in Germany. He is the author and coauthor of several works on monetary policy and political economy, including *Inflation Targeting: Lessons from the International Experience* (1998) and *Disciplined Discretion: The German and Swiss Monetary Frameworks in Operation* (1997). As part of the IIE's response to the Asian financial crisis, he has been working intensively since the fall of 1997 on Japanese macroeconomic policy, and he is the author of *Restoring Japan's Economic Growth* (1998).

Soichi Shinohara
Professor of Economics, Doshisha University

Mr. Shinohara is currently professor of economics at Doshisha University in Kyoto, Japan. His areas of interest include international economics and applied macroeconomics. His expertise also includes specific research on the U.S. and Chinese economies. Mr. Shinohara is an honorable professor of economics at both the People's University of China and Xibei University. He has authored and coauthored many publications, his most recent book being *Principles of Economics* (1999). Mr. Shinohara is a graduate of the University of Tokyo, and has attended the University of Chicago. He has a Ph.D. in applied economics from the University of Waterloo.

Robert B. Zoellick
President and CEO, Center for Strategic & International Studies (CSIS)

Mr. Zoellick has been President and CEO of CSIS since January 1, 1999. During the 1997-1998 academic year, he was the John M. Olin Professor of National Security Affairs at the U.S. Naval Academy. From 1993 to 1997, Mr. Zoellick served as executive vice president at Fannie Mae, the largest housing finance investor in the United States. From 1985 to 1988, Mr. Zoellick served at the Department of the Treasury in various positions, including counselor to Secretary James A. Baker III, executive secretary of the department, and deputy assistant secretary for financial institutions policy. During the Bush administration, Mr. Zoellick served as counselor of the Department of State (undersecretary rank) and undersecretary of state for economics. He later served as deputy chief of staff at the White House. Mr. Zoellick received the Distinguished Service Award, the Department of State's highest honor. The German government awarded him the Knight Commanders Cross for his role in developing the U.S. strategy toward German reunification and his service as the senior U.S. official in the "2 plus 4" negotiations. Raised in Naperville, Illinois, Mr. Zoellick received a J.D. magna cum laude from the Harvard Law School and a Master of Public Policy degree from Harvard University's Kennedy School of Government. He is a Phi Beta Kappa graduate of Swarthmore College.