Introduction

Since the end of World War II, Japan has changed dramatically. Such change, however, has been linear, in that it has invariably taken place within a framework established by the bureaucracy, and has been producer-oriented rather than consumer-oriented.

Japan is now going through another change, but unlike its previous adjustments, this time it seeks to change direction and alter the basic structure of the Japanese political and economic system. The outcome will not only affect Japan, but also its relationship with the United States and the world, marking in many ways a critical turning point in its history.

These current changes have been triggered by both economic and political circumstances.

Economic Circumstances

Economic growth policies of the Japanese government during the 1980s resulted in extremely low real interest rates and a high degree of bank lending, which created a speculative "bubble." The resulting heavy borrowing, investment, and conspicuous consumption, were predicated on the mistaken assumption that Japan's economy could move in only one direction: up.

The bursting of the bubble in late 1989 ended Japan's delirious party. The aftermath is a hangover of a recession that will take more than two aspirin, hot coffee, and a cold shower to cure.

A look at the damage is revealing. Between December 1989 and August 1992, the Nippon dropped 60 percent. Real estate prices are down about 30 percent from their 1991 peak, and still sliding. Industrial production has dropped for two consecutive years, and car sales have now fallen for ten straight quarters. Economic downturns in Japan's major overseas markets have added to the business sector's woes. The list goes on and on.

This combination of internal and external factors has had a measurable, negative effect on the nation's economy. Second quarter GNP for 1993 was

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minus 0.5 percent from the previous quarter, roughly equivalent to an annual rate of minus 2.0 percent. All things considered, I think it is rather remarkable that the economy had managed to maintain positive GNP growth for this long, and to keep unemployment limited.

What is important to understand here, though, are the unique features of this recession that distinguish it from past recessions, and as such require more fundamental adjustments to cure.

For example, from a cyclical point of view, this recession should be basically over. Inventory adjustment, typical in a cyclical downturn, has been carried out near to completion, and major overseas trading partners in Asia and North America continue to be strong or are finally recovering. Normally this would be sufficient to spark the Japanese economy.

Unfortunately, the negative effects of the 1980s boom remain. For one, there is now serious excess capacity in Japan's plants. Moreover, there is a problem of excess labor. Much of the hiring carried out during the boom years has become a liability. Some firms have already embarked on layoffs, many for the first time in their history.

Restructuring is not only limited to manufacturers. To no one's surprise, the bursting of the bubble has exposed structural weakness in the financial sector, requiring emergency efforts by the Ministry of Finance to rescue many of Japan's top banks, trusts, and securities institutions.

All of this has led to lower consumer confidence, which in turn decreases domestic consumer demand for products and services. It does not help that, thanks to heavy consumption encouraged during the 1980s, the consumer market is now fairly saturated for most products, further lowering domestic demand. Consumers are also changing their spending patterns, shifting from conspicuous consumption of luxury products to more basic requirements. The obvious effect is a concurrent drop in business income and a slowing of GNP growth, resulting in a downward spiral that is difficult to overcome.

To make matters worse, the Japanese economy this year has been buffeted by several external and internal factors that have dashed any hopes for positive growth in FY 1993. First among these is the tremendous rise in the value of the yen. Averaging about ¥125 to the dollar in January of this year, the yen rose to nearly ¥103 to the dollar in August, an appreciation of 21 percent.

The damage this has done to the income of Japanese exporters and to the Japanese economy cannot be overstated. And as of yet, the positive effects on consumer price levels due to cheaper imports have yet to be fully realized, doing little to boost flagging domestic demand. Adding insult to injury, the unusually cool, wet summer this year also hurt. Sales of everything from beer to air conditioners to electricity, have been down substantially.

Internally, one cannot overlook the negative effect of seemingly endless scandals, most recently highlighted in the construction industry. Especially at a time when increased fiscal stimulus in the form of public investment would