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How Able Is Abe?

By Richard Katz and Peter Ennis

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Summary: Shinzo Abe has had a tough act to follow since succeeding the charismatic Junichiro Koizumi as Japan's prime minister. Abe has already shown himself to be adept in the field of foreign affairs, and Tokyo's influence is likely to increase with him at the helm. But it remains uncertain whether he can keep the momentum going on the reforms needed to stave off economic stagnation.

Richard Katz and Peter Ennis are Co-editors of "The Oriental Economist Report," a monthly newsletter on Japan, and the semiweekly "TOE Alert." Katz is also the author of "Japanese Phoenix: The Long Road to Economic Revival."

A SOFTER TOUCH FOR JAPAN

When Junichiro Koizumi retired as Japan's prime minister last September, he left big shoes to fill. Although major reforms to Japan's economy had begun years prior to his election in 2001, Koizumi greatly advanced the process -- in part through specific achievements, but more important by catalyzing public demand for change and by giving reform an aura of inevitability. Now Shinzo Abe, his handpicked successor, will have to live up to the expectations Koizumi created.

At first glance, Abe seems a study in contradiction. He is Japan's first prime minister to be born after World War II, yet he draws inspiration from his late grandfather, Nobusuke Kishi, a wartime leader imprisoned for three years after Japan's surrender. Although Abe is often misperceived as an ultranationalist, he has worked hard since taking office to repair frayed ties with China and South Korea, making concessions that his less nationalist predecessor had refused to make. By confounding expectations, Abe has raised some big questions at home and abroad. First among them: In what ways, exactly, will he act like Koizumi, and how will he be different?

Consider the similarities first. Like Koizumi, Abe reflects and embraces Japan's ongoing metamorphosis. Both men recognize the passing of the old Japan of the 1970s and 1980s, which was characterized by passivity in foreign affairs and a highly regulated corporatist economy that protected inefficient firms and industries. That Japan was a casualty of the bursting of the asset bubble in 1990, the lengthy economic stagnation and banking crisis that ensued, the collapse of the Soviet Union, and the emergence of a more assertive China and a nuclear-armed North Korea.

Like Koizumi, Abe understands that Japan's increasingly urban and educated population needs and expects ongoing economic reform. When Koizumi repeatedly warned that there could be no growth without structural reform and sought to marginalize recalcitrant factions of his own ruling Liberal Democratic Party (LDP), Abe, in a variety of posts concluding with chief cabinet secretary, stood with him. The two men are also united by a shared understanding that changes in global geopolitics require Japan to modify its relationship with the United States by becoming a more active partner. Tactics aside, both Koizumi and Abe accept that close ties with Washington are critical to dealing with the North Korean nuclear threat.

Underlying the similarities, however, are differences in personality and policy priorities. Koizumi as prime minister was a charismatic, iron-willed maverick and a loner; Abe is a staid and collegial pragmatist who, at the relatively young age of 52, may have a harder time imposing his will on the bureaucracy and the LDP. As prime minister, Koizumi focused on political and economic reform; he defined the latter narrowly, mostly as reducing the state's role in the economy. Abe, on the other hand, seems intent on emphasizing foreign policy and conservative domestic social issues, such as giving Japanese youths a more "patriotic" education.

Koizumi's main political tactic was to successfully portray politics as a conflict between good guys (reformers) and bad guys (the resistance). His legendary stubbornness sometimes made him look steadfast and at other times mule-headed. Consider, for instance, the controversy surrounding the Yasukuni Shrine. Before taking office, Koizumi had never visited the site, where two and a half million Japanese war dead (including 14 convicted World War II-era war criminals) are enshrined. But during the 2001 campaign, he promised to go, and Koizumi duly visited the shrine every year after that, thereby enraging China and South Korea. Beijing cut off all summit meetings, and violent anti-Japan demonstrations wracked several Chinese cities in 2005. Despite

pleas from Japanese political and business leaders, Koizumi refused to break his pledge and abandon the visits.

Abe has already evinced a very different style. Even before taking office, Abe used back channels to arrange fence-mending trips to Beijing and Seoul, where he flew two weeks after assuming power. Chinese President Hu Jintao, who was also anxious to repair ties, accepted Abe's silence about whether he would visit Yasukuni. As long as Tokyo's ties to Beijing and Seoul remain solid, Abe will probably avoid the shrine. North Korea's testing of a nuclear device reinforces the notion that China, South Korea, and Japan share some common interests, and Abe's approach already seems to be paying off; despite some remaining differences, China's Foreign Ministry declared soon after the summit that "China-Japan relations are back on course."

Whereas Abe's pragmatism has worked on the foreign front, so far it has had a much less positive impact domestically. Koizumi's foremost economic goals were reducing spending on public works, cutting government regulation, and privatizing myriad state enterprises. Koizumi saw these enterprises (which produced ten percent of Japan's GDP when he came to power) as cancers that drained the economy, encouraged corruption, and funded retrograde politicians. Initially, he failed to grasp that economic recovery also required an urgent, drastic reduction in the mountain of nonperforming loans (NPLs) held by Japan's banks. But by late 2002, he had been convinced that action was necessary and, with the help of his chief economic aide, Heizo Takenaka, managed to get Japan's banks to reduce their NPLs far more than they would have done on their own. Then, in 2005, he tried to privatize Japan's postal system (which includes the largest bank in the world in terms of assets). The effort failed, but it sparked a dramatic political showdown in which Koizumi expelled a few dozen rebels from the LDP who had helped defeat the effort. He then called snap elections for the lower house of Japan's Diet as a referendum on "reform or not; small government or not" and managed to win an overwhelming two-thirds of the seats. The new parliament quickly passed his postal-reform bill. The episode further strengthened the prime minister's power at the expense of the bureaucracy and LDP barons.

Abe is part of the younger generation that wants to continue enhancing the prime minister's power, but his conciliatory style may prove an obstacle. To help his party win this July's elections for the Diet's upper house -- a victory vital to his leverage and his ability to stay in office -- Abe announced soon after taking office that he would readmit nearly a dozen "postal rebels" into the LDP once they pledged obedience (a promise he has now delayed fulfilling in the face of a public uproar). The move may have been expedient, but it hurt his public-approval rating, which fell from 71 percent to the low 50s. When Abe then made a concession to the road-building lobby, his popularity fell further. The compromise was not unlike some of those made by Koizumi. But because Koizumi worked hard to fashion a public image as a reformer, the public forgave him for his occasional backsliding. By contrast, first impressions of Abe are that he has betrayed the 2005 election results for the sake of political expediency. Hence, what the public would forgive in Koizumi it will not in Abe.

The new prime minister now seems unlikely to attempt any economic reforms (other than budget cuts) in the near future, at least not until after the July elections. Abe has no desire to turn back the clock, but neither does he seem willing to fight hard for further reform. This summer's elections will help determine his capacity to push the reform process. Whatever the results, however, he cannot ignore the economy indefinitely. Internationally, he can be expected to take additional steps toward making Tokyo a more active ally of Washington while simultaneously making Japan more independent. But antireformers at home are already testing his power. If Abe wants to create real change, or even keep his post for very long, he will have to become as assertive within Japan as he has been abroad.

THIRST FOR INDEPENDENCE

Before Abe's election, many analysts worried that as a purported hard-liner Abe would further damage Japan's relations with its neighbors. His snap visits to Beijing and Seoul shortly after taking office showed that the truth is more complex. Like Koizumi, Abe wants Japan to play a bigger role on the regional and global stage. But the two leaders differ on some specifics.

During Koizumi's five-year tenure, Japan's relations with China hit an all-time postwar low, in large part because of Koizumi's almost reckless insistence on visiting the Yasukuni Shrine. Koizumi seemed to revel in defying Beijing's demands that he stop the visits; the diplomatic skirmishes seemed to fuel his competitive fires. At the same time, Koizumi launched unexpected diplomatic initiatives toward North Korea, hoping to lure its isolated regime into more stable ties with the rest of the world. Abe, by contrast, has moved quickly to smooth China's ruffled feathers. But he has retained the very hard line toward North Korea that helped propel him to popularity inside Japan. Abe insists that Pyongyang must fully account for the dozens of Japanese citizens kidnapped by North Korea's secret services over the past 30 years. But Abe shares Koizumi's view that Japan has to start exercising its diplomatic independence, even if this occasionally means disagreement with Washington. Both men see this as natural for a "normal" nation.

Abe's reputation as a nationalist owes in part to his extraordinary devotion to the memory of his grandfather Kishi, who served in the wartime cabinet of General Hideki Tojo and, after Japan's defeat, spent three years in

prison as a suspected Class A war criminal. After his release in 1948, Kishi went on to found the civic group Nippon Saiken Renmei (Alliance to Rebuild Japan), which pushed to revise Japan's postwar, U.S.-drafted constitution and gain greater freedom on foreign and military matters. As prime minister from 1957 to 1960, Kishi is best remembered for renegotiating the U.S.-Japanese security treaty in 1960, giving it somewhat greater balance. But it is often forgotten that shortly after taking office, Kishi also became the first postwar prime minister to visit neighboring Asian nations. It was only later that he made the obligatory visit to Washington. Perhaps by necessity, perhaps by desire, Abe has followed his grandfather's path as prime minister step by step. This is not to suggest that Abe has whitewashed history; he acknowledges the huge mistakes and crimes committed during Japan's imperialist heyday. But he insists that the true wartime record is more complicated than it is often portrayed: that not everything Japan did was wrong and that not everything the Allies did was right. In particular, he rejects many aspects of the war crimes trials that sent his grandfather and others to prison.

Despite these sentiments, Abe is also the first Japanese prime minister to be born after World War II and thus represents a changing of the guard in Tokyo. He has a mental foot in two worlds: that of his grandfather, who started out as an imperialist but then became one of the engineers of Japan's great postwar revival, and that of Japan's younger generation, which yearns for a day when the country is no longer judged -- and no longer judges itself -- by its past crimes.

It is as a member of this younger generation that Abe has set out to eliminate the taboos that he believes undermine Japan's independence. He is by no means anti-American; indeed, Abe supports Japan's security relationship with the United States. But he is also proudly pro-Japan. He argues that since Japan has been peaceful, economically vibrant, a good neighbor, and a contributor to international peace for over 60 years now, there is no more need for war guilt. In his view, it is time for Japan to become a normal country, which means adopting a homegrown constitution, promoting patriotism in schools, and accepting a greater role in international security.

Abe is also well aware that Japan's neighborhood has changed in recent years. The end of the Cold War, the emergence of North Korea's nuclear threat, and China's robust military buildup have all underscored the fact that Japan can no longer remain passive about protecting itself or rely entirely on the United States. Abe is by no means alone in holding this belief; it has become conventional wisdom in Japan. The pacifist left has almost disappeared, and the far right has no credibility. Meanwhile, both the center-left Democratic Party of Japan (DPJ) and Abe's center-right LDP now support a bigger Japanese security role. Both endorse revising the constitution to fully legitimize Japan's armed forces, and both think Japan should engage in collective-security operations with other nations. Until now, successive Japanese governments had concluded that cooperative military endeavors, except those to defend Japan, would violate Article 9 of the constitution (which prohibits the use of force to settle international disputes). In this view, Japan did not even have the legal right to aid a U.S. naval vessel if it came under attack by North Korea in international waters. The DPJ now argues that Tokyo should engage in collective operations when authorized by the United Nations. The LDP has taken a more assertive stance, supporting joint operations with the United States with or without UN authorization.

Accordingly, Japan has steadily tried to put in place a modern national security infrastructure in recent years. The Japan Defense Agency, which recently gained the status of a full ministry, established a defense intelligence headquarters shortly after the first Gulf War and has carefully placed bright young leaders in overseas posts. Tokyo has also established a satellite reconnaissance program to keep a close eye on North Korea. The program is rudimentary by U.S. standards, but it nonetheless represents a major step forward for Japan, and the United States has begun to train Japanese analysts to interpret the satellite photos themselves. The United States and Japan upgraded their bilateral defense alliance in 1996, allowing for greater joint contingency planning. Koizumi greatly expanded the office of prime minister, in both personnel and stature. Abe plans to do more of the same and has often talked of creating a U.S.-style national security council in his office.

Abe will almost surely support, and even expand, research-and-development cooperation with the United States on theater missile defense, again in reaction to the behavior of North Korea. Since a theater missile defense system controlled by Japan's armed forces would almost surely have to rely on U.S. intelligence and early warning capabilities, it would accelerate official acceptance in Japan of joint security operations with the United States.

Diplomatically, Abe is likely to expand initiatives that are independent of (but in no way damaging to) the U.S.-Japanese alliance, including increasing ties with India and Vietnam, which provide useful counterweights to China.

One thing Abe is unlikely to change, however, is the basic defensive nature and structure of Japan's armed forces. Japan has virtually no power-projection capabilities: no sea-based landing vessels to ferry large numbers of troops, no heavy-lift aircraft to quickly transport equipment and soldiers to foreign lands, no long-range bombers, no significant in-air refueling capability to extend the range of jet fighters capable of delivering

missiles, no aircraft carriers to bring jet fighters within range, and no ballistic missiles. There is very little in the Japan Defense Agency's procurement plans that even hints at a fundamental change, although Tokyo is likely to expand its ability to deal with potential skirmishes with Beijing and Seoul in disputed waters.

Under Abe, Japan can also be expected to continue to rely on the U.S. nuclear umbrella. The issue of a Japanese bomb became a subject of heated discussion late last year, when several Abe aides suggested that Japan should at least discuss acquiring the bomb. Abe forcefully rejected the notion of a nuclear-armed Japan, as did many important Japanese foreign policy specialists. At the same time, however, the prime minister defended his aides for having raised the issue, suggesting that in contemporary Japan no topic should be taboo. Still, there is no evidence that Japan has started developing the early warning systems, command-and-control systems, or delivery capabilities that a serious nuclear deterrent would require.

So far, Japan's growing assertiveness has been accepted (if not welcomed) by its neighbors, who are reassured by Tokyo's continued close ties to Washington. Most Asian countries seem to recognize that so long as Japan remains partnered with the United States, it is unlikely to threaten their interests. For its part, Washington should also be able to adjust to a more self-confident Japan. This may mean giving Tokyo a bigger role in the management of the alliance and a seat at the table for crucial discussions, such as about how to deal with Iran's nuclear weapons program (since Japan is one of the largest purchasers of Iranian oil). But that seems a small price to pay for Japan's cooperation on a host of security and diplomatic fronts. At the end of the Cold War, many analysts worried that the disappearance of the Soviet threat would undermine the purpose of the U.S.-Japanese alliance. Exactly the opposite has happened, as the two countries have found that they need each other more than ever, if in different ways.

THE GROWTH GAP

Despite substantial reforms over the past decade, the economy Abe inherited still faces a dizzying array of problems. With every passing year, Japan will have more retirees but fewer workers to support them, a mismatch that will strain both living standards and the government's budget. To offset this demographic shift, Japan's shrinking work force needs to become much more productive. Unfortunately, it has yet to even begin to do so. To raise more funds, Tokyo proposes to increase consumer taxes. But this move will be extremely unpopular and could undermine consumer spending.

Abe often speaks of the need for growth, but he lacks any comprehensive strategy to achieve it. He is unlikely to undo the positive changes enacted over the last few years. Even if he wanted to (and there is no sign that he does), some of the reforms have taken on lives of their own. Moreover, as shown by the 2005 elections, the idea of reform (even if poorly defined) remains exceedingly popular. That said, there is a real risk that the momentum for reform created by Koizumi will slow or even stall. Abe's passion is foreign and social policy, not economics. Moreover, his economic team is weak. Koizumi had a strong economic czar in Takenaka, his minister for economic and fiscal policy. Together, they turned the cabinet's Council on Economic and Fiscal Policy (CEFP) into the government's primary economic decision-making body. So far, Abe has found no equivalent ally. Some of his appointees, such as Chief Cabinet Secretary Yasuhisa Shiozaki, are both ardent reformers and economic experts. But without Abe's deep personal engagement, Shiozaki will lack sufficient clout to get much accomplished. Moreover, Abe's new minister for economic and fiscal policy, Hiroko Ota, is seen as a lightweight. Other Abe aides seem to think of reform as amounting to little more than deficit reduction, and too many of Japan's business leaders seem content to let past corporate restructuring take its course without pushing for further improvements.

Some political and business leaders claim that Japan's economy has already recovered, pointing to the steep reduction in NPLs held by Japanese banks and the country's 2 percent annual economic growth since 2002. However, five years of zero growth prior to 2002 had left the economy operating at 4 percent below full capacity. The high growth rate of the last few years should therefore be understood as a correction, and it is not sustainable. Indeed, newly revised estimates of GDP show that since early 2004, Japan's economy has increased by a mere annual growth rate of 1.5 percent. The cabinet office has forecast medium-term potential growth -- that is, the speed the economy will grow if it achieves full employment and full use of physical capacity -- at only 1.4 percent. Optimists forecast annual growth at 2 percent, a figure that only a decade ago reformers called a comedown, not a goal.

Offsetting these trends will not be easy for Abe. His five-year budget assumes that Japan will enjoy 2 percent GDP growth per year through 2011. But with the working-age population projected to decrease by 0.6 percent a year through 2010 and by 1.3 percent between 2011 and 2015, this growth will have to come from better productivity. Yet Japan's productivity has grown by an average of only 1.5 percent for the last 15 years. Unless substantially more of the aged or more women join the labor force, to meet Abe's target, productivity growth would have to leap to 2.6 percent a year through 2011 and then to 3.3 percent. Without more reform, such progress is unlikely.

To enhance productivity and sustain consumer demand, Tokyo needs to enact a broad range of reforms: strengthen capital markets, boost consumer income, end Japan's "dual economy" (which features efficient exporters and inefficient domestic sectors), increase competition, encourage corporate reform, and promote inward foreign direct investment (FDI) and imports. On some of these issues, Tokyo has made notable progress over the last decade -- but not enough to reach critical mass.

For example, it is true that between 2002 and March 2006, NPLs were cut from 8.4 percent of total loans to 2.9 percent (1.8 percent at the biggest banks). However, behind every bad loan is a bad borrower, and until recently, 14 percent of all bank loans charged less than 0.5 percent interest. That made poor borrowers able to appear up-to-date on their payments. Now, as cut-rate loans shrink with the Bank of Japan's departure in July 2006 from its zero-percent interest-rate policy of the previous six years, bankruptcies are starting to rise. Abe will face pressure to rescue small and medium "zombie" borrowers, especially in key voting districts.

Japan also needs to balance its bank-dominated financial system with stronger capital markets. It has made some progress in this area in recent years, especially thanks to the foreign-asset managers who were unleashed by the "Big Bang" reforms in 1998. But Japan's cash-rich corporations remain largely immune to market discipline, and there are no strong capital markets to force them to return their excess cash to households, where it could be spent or invested in better companies. In the 1950s, Japanese households held a majority of the country's stocks. But in the 1960s, Tokyo began encouraging corporate cross-shareholding to fend off foreign acquisitions. As a result, Japan's households today own only a fifth of all shares. Meanwhile, foreigners have upped their ownership of Japanese shares to a quarter of the total, sparking talk of increased shareholder power. But most Japanese corporations have rebuffed pleas to pay dividends comparable to those in the United States or Europe. And little corporate governance reform has been conducted. Most "outside" directors on Japan's corporate boards still come from the firms' own banks, insurers, or allies. Having appointed a weak financial services minister, Yuji Yamamoto, Abe is failing to correct the slow pace of progress.

In addition, Japan's recent economic recovery remains severely unbalanced. Business investment has accounted for a record 40 percent of GDP growth since 2002. But investment cannot grow several times faster than GDP indefinitely. A rising trade surplus, aided by the weakest price-adjusted yen since 1985, has supplied 38 percent of growth since 2002. That cannot continue either.

By contrast, Japanese consumption has lagged, due in part to a surge of low-paid "irregular workers" (temps and part-timers), who now represent an unprecedented one-third of Japan's labor force. Near-zero interest rates on savings and the fact that total price-adjusted compensation for all workers was only two percent higher in late 2006 than it was in 1997 have hurt the incomes of Japan's consumers. Despite lower unemployment, which usually boosts real wages, pay per worker fell again in 2006 in real terms. Consumers have accrued some additional income from temporary tax cuts and government payments such as social security. But Tokyo is now rescinding these tax cuts, hiking pension and health-care premiums, and cutting benefits. To get by, Japanese households have had to lower their savings rate from 10 percent in 1996 to 3 percent in 2005. Almost 25 percent of all households now have no savings left, up from 8 percent a decade ago.

Yet, soon after Abe's ascension, the new finance minister, Koji Omi, proposed a tax cut for companies, and, under Abe's orders, he is waiting until after the July elections to discuss the Finance Ministry's well-known desire for a big tax hike on consumers. Moreover, Abe has chosen Fujio Mitarai, chair of both Canon and the business lobbying group Nippon Keidanren, for membership on his CEFP. Given that no less than 70 percent of Canon's employees are irregular workers, up from 10 percent a decade ago, and that Nippon Keidanren has demanded further wage restraints in 2007, the move hardly bodes well for consumer income.

DOUBLE JEOPARDY

For decades, Japan has had a "dual economy," with efficient exporters but highly inefficient domestic companies. The chief cause of this problem has been insufficient competition. Yet Abe, like Koizumi, has disregarded the issue, virtually ignoring the structural flaws in the private economy.

Abe likes to claim that economic growth can be spurred by exotic industries such as nanotechnology. But he overlooks the fact that productivity improvements can and should come from modernizing lagging industries. In the United States, old-line businesses such as retail, banking, and rust-belt manufacturing have been responsible for a majority of the leap in productivity since 1995. According to the economist David Weinstein, bringing Japan's backward industries up to global standards over 20 years could add 1.5 percent to productivity each year.

To be fair, the Japanese government has driven some corporate restructuring. New consolidated accounting and taxation rules have prevented firms from hiding their losses in subsidiaries. Auditing is now more honest, due to changes that made it easier to sue auditors and board members and that strengthened regulatory oversight. These reforms, plus the NPL crisis, have forced managers to pay more attention to profitability. Some firms have

sold off their noncore operations, and mergers and acquisitions have shaken things up. But too many mergers have simply amalgamated sick firms in troubled industries. Worse yet, the Ministry of Economy, Trade, and Industry (METI) is now pushing Abe to weaken antitrust policy even further. Today, the Japan Fair Trade Commission (JFTC) almost automatically approves mergers so long as the merged firm's market share would not exceed 35 percent. METI wants to raise the threshold to 50 percent.

Lately, some companies have revived cross-shareholding to fend off potential buyouts. No hostile takeover has ever succeeded in Japan. Eventually, some will. Although such takeovers should remain rare, as they are in the United States, merely allowing for their possibility would help deter bad management.

Except in a few sectors, it remains difficult for new firms to seize market share from entrenched ones. Japan has the developed world's lowest rate of firm turnover (that is, of firms exiting and entering markets). Yet such turnover is vital to efficiency. One reason Japan lags in this area is that too many of its corporations tend to collude on matters such as rigging bids for public works projects, dividing up markets, and erecting barriers to entry for potential competitors (both foreign and domestic). The JFTC is notoriously weak in fighting such practices. Another problem is Japan's lifetime employment system for core workers and managers. Corporate reform requires labor mobility, and vice versa. So far, Abe has yet to put any of these issues on his agenda, ignoring them just as Koizumi did. Instead, some of his advisers point to the widespread corporate malfeasance epitomized by Enron and WorldCom and oppose needed changes, describing them as part of "an American money game" that fosters a pernicious corporate environment.

One of the best cures for the dual economy would be to increase imports and incoming FDI. After all, Renault, which acquired Nissan in 1999, managed to transform the virtually bankrupt company into one making record profits. Japan has almost fulfilled Koizumi's pledge to double incoming FDI to 2.5 percent of GDP, and Abe has vowed to double or triple this figure by 2010. Such increases would have a catalytic impact, although they would still leave Japan far behind the United States and the European Union (where FDI represents 14 percent and 33 percent of GDP, respectively). And Japan will have a tough time reaching Abe's targets. Just one obstacle is the tax applied to stock-for-stock swaps, the main method by which foreign firms buy healthy businesses. A tax reform scheduled for 2007 is supposed to make things easier, but that depends on how the new law is interpreted. Nippon Keidanren is resisting the reform, as are some in Japan's bureaucracy and in the LDP. If they succeed in stalling things, FDI will keep growing but not by enough.

On a positive note, imports of goods and services have increased from 7 percent of real GDP in 1994 to 11 percent in 2006. That is real progress, even though the ratio remains low by global standards. Unfortunately, the growth in manufactured imports has mostly come from foreign affiliates of Japanese firms, rather than from truly foreign companies that would provide real competition. Abe has proposed signing more free-trade agreements with Japan's neighbors, which could address this problem if they are combined with a stronger competition policy and a change in business practices. They could also help Japan catch up with China on the diplomatic front. But Japan's few existing free-trade agreements have contained too many loopholes to truly boost competition. Japan's powerful farm lobby has successfully limited efforts to lower tariffs and quotas, and the trend seems likely to continue: Abe appointed Toshiakazu Matsuoka, a notorious hard-line leader of the Diet's "farm tribe," as agriculture minister. At a November CEFP meeting, Matsuoka defeated an attempt to include the abolition of agricultural barriers in Japan's trade-negotiating agenda. Free-trade talks with Australia, slated for this year, will be a key test case for the reformers' ability to beat the farm lobby.

While such problems persist, another growing source of public discontent has been worsening income inequality and poverty in Japan. The country's poverty rate is now the second highest in the developed world, higher than in every other developed country but the United States. Those opposed to reform have blamed Koizumi for this crisis. In reality, inequality began rising two decades before Koizumi's ascension to the prime ministership. Abe has pledged to offer "a second chance" to those suffering from economic malaise as a consequence of the reforms, but he has been very vague about how to do it. His goal is laudable, but it needs to be pursued in ways consonant with general economic growth. Traditionally, Japan has covertly addressed such problems by quietly shifting income from efficient sectors to inefficient ones, such as when Toyota paid high prices for inputs such as steel and glass and its workers paid high prices for food and housing. But this process led to bloated staffing in inefficient sectors. Make-work projects in rural areas also spread around the nation's riches but hurt efficiency. Deflation and budget cuts have made both of these tactics less viable.

A better approach would be to combine labor reforms, overt redistribution through government tax and spending programs, and financial reforms to help households become investors. Current rules hinder layoffs of redundant full-time workers, which encourages firms to hire temps and part-timers. Abe should push to equalize the working conditions of regular and irregular workers and expand the social safety net for workers in transition. Unfortunately, the drive to cut budgets has moved him in the opposite direction.

RELUCTANT REFORMERS?

It is important to remember that, like Abe, Koizumi was initially reluctant to address certain problems (such as NPLs) -- until worsening circumstances forced him to. The same may happen to Abe. Lackluster economic growth and the aging of Japan's population will put grinding financial pressures on voters. Since they will not ignore these problems indefinitely, neither can Abe.

Fortunately, Abe's ambitious security goals could intersect with Japan's economic needs. Abe's desire to counterbalance China has already boosted his interest in free-trade agreements, for example. To secure such agreements, Tokyo will have to make concessions on agricultural protections and other issues, moves that should help Japan's economy.

Abe has already surprised observers with his trips to Beijing and Seoul. Once he understands the depth of Japan's economic problems, his advisers in and out of government can help him to confound the pessimists yet again. Although he lacks Koizumi's gravitas and popularity, Abe has enough power to bypass government foot-draggers and take charge. When, or whether, he will do so is uncertain. What is clear is that failure to take action would not only jeopardize Abe's longevity but also condemn Japan to lackluster growth, stagnant living standards, and diminishing global influence. Hence, even if Abe does not do the right thing, Japan eventually will.

HOW TO SOLVE A PROBLEM LIKE YASUKUNI

The Yasukuni Shrine was founded in 1869 by Emperor Meiji to commemorate those who died in the nation's then-recent civil war (the name "Yasukuni," chosen by the emperor, means "peace for the nation"). Since then, it has been expanded to honor the approximately 2.5 million Japanese who have died in the country's various conflicts. Most controversial, in 1978, Yasukuni's administrators decided to secretly enshrine 14 people convicted by the Tokyo War Crimes Tribunal as Class A war criminals, including former Prime Minister Hideki Tojo. Emperor Hirohito was so angry about the move that he steadfastly refused to visit Yasukuni. His son, the current emperor, has maintained that stance.

The relationship between the government and the shrine has always been vague. It was founded by the head of state and is a Shinto monument -- and Shinto was long Japan's national religion. But after World War II, the U.S.-written constitution mandated the separation of church and state. Legally, Yasukuni became an independent entity. Spiritually and emotionally, the separation has been less clear. The monument was hijacked long ago by romantic ultranationalists. But Yasukuni remains a place that even some liberals and leftists visit to make peace with relatives who died in Japan's wars.

Prime Minister Abe's visits to China and South Korea helped push the problem of the shrine to the political back burner. For now, Beijing and Seoul have accepted Abe's "don't ask, don't tell" approach to Yasukuni. As long as Abe does not visit the shrine, Beijing and Seoul seem willing to tolerate its existence. But the problem will not go away so long as the war criminals remain in place and the shrine's adjacent museum (Yushukan) seems to exonerate Japan for its behavior during World War II.

How, then, should the controversy be resolved once and for all? The Yasukuni Shrine raises and encapsulates many unresolved issues in Japan about national identity and war responsibility. As long as there is no consensus on these broader issues, the Yasukuni problem will continue to loom large. In the meantime, however, some measures could help reduce friction. Yasukuni's shadowy authorities have apparently agreed to allow a group of outside experts to rework some of the most contentious aspects of the museum. As for the shrine itself, some have proposed removing the 14 Class A war criminals, but the families of the deceased -- especially Tojo's descendants -- have fiercely resisted such a move. A more promising solution would be the creation of a new national monument elsewhere honoring the victims of Japan's wars. This would allow Japan's royal family to honor the sacrifice of Japan's war dead while avoiding any endorsement of Japanese aggression. And it would allow Abe and his successors to pay their respects without provoking the ire of Japan's neighbors.

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