

Report for Congress

Received through the CRS Web

Japan's Economic and Security Challenges

October 16, 2002

Dick K. Nanto
Specialist in Industry and Trade
Foreign Affairs, Defense, and Trade Division

Japan's Economic and Security Challenges

Summary

This report provides a snapshot of U.S.-Japan relations, current economic and security challenges facing Japan, and policies being adopted or considered to deal with them. The information was gathered primarily during a trip to Japan in February 2002 and augmented by subsequent research.

Japan's economy is beginning to recover from its third recession over the past twelve years. This "lost decade of the 1990s" and slow growth means that Japanese gross domestic product is as much as \$1.3 trillion dollars (equivalent to Brazil's GDP) below what it could have been if it had continued to grow at the 3.6% rate it did in the 1980s. Japan's economy faces three basic problems. The first is the legacy of the bursting of the economic bubble in 1989 that includes a large accumulation of nonperforming bank loans and deflation. The second is the current global recession, and the third is globalization.

The largest immediate economic problem for Japan is the \$417.7 billion in nonperforming loans held by its financial sector despite a decade of government programs (which critics call half-hearted) to strengthen Japanese banks and private efforts to clean up the financial mess. This is causing credit to contract, monetary policy to be less effective, and contributes to the ongoing recession. Economic policymakers realize that if they do not act aggressively, market forces may accomplish what policy will not. Japanese government bonds already are being downgraded; bankruptcies are rising; a major capital flight out of yen denominated assets could occur; a premium on borrowing by Japanese banks could return, or financial instability could begin in Japan that could spread to other countries. In a move that reflects near desperation, in September 2002, the Bank of Japan announced that it would consider directly purchasing stock shares held by more than a dozen Japanese banks. In October, Prime Minister Koizumi reshuffled his cabinet to enhance the authority of reformist leaders and promised aggressive action by month end. The Bush administration has become more vocal in articulating its desires for Japan to move forward to rehabilitate its economy and has advocated that Japan cut taxes and clean up the bad loan problem to spur investment and economic recovery.

In the security area, Japan responded to the September 11 terrorist attacks on the United States by approving new laws that allowed its Self-Defense Forces to directly assist the U.S.-led war on terrorism. The Japanese navy was sent to the Indian Ocean to transport nonlethal supplies and provide fuel and other supplies to U.S. forces. This was the first time since World War II that Japan's navy had been allowed to operate outside of its home waters. Japan also is strengthening protection of its nuclear plants and taking other measures to counter the new terrorist threat.

Japan is concerned over the rise of China and is seeking normalization of relations with North Korea. Japanese businesses are investing heavily in China – often to the detriment of local manufacturing. Japan is concerned that it could be drawn into the China-Taiwan dispute.

Contents

Introduction	1
Japan's Economic "Crisis"	3
Burst of the Asset Bubble	5
Global Recession	6
Globalization	6
Nonperforming Loans	7
Koizumi Government Economic Policies	9
Nonperforming Loans	9
Inflation Targeting	11
Yen Depreciation	11
Trade Policy	11
U.S. Policy Options on Japan's Economy	13
Terrorism and Security Issues	15
Response to September 11	15
Iraq	17
New Terrorist Threats	17
Japan's Military	18
North Korea	18
China	19
Taiwan	21
Senkaku (Daioyu) Islands	21
Theater Missile Defense	22
The Kyoto Protocol	22
Bush-Koizumi Summit	23
Conclusion	23

List of Figures

Figure 1. Japanese Bank Balance of Nonperforming Loans and Cumulative Direct Writeoffs by Banks, FY1991-2001	9
---	---

Japan's Economic and Security Challenges

This report provides a snapshot of U.S.-Japan relations, the current economic, security, and other challenges facing Japan, and policies being adopted or considered to deal with those challenges. The information was gathered primarily through a trip to Japan by a delegation of congressional staff in February 2002 and augmented by subsequent research.¹ The delegation met with high-level Japanese government officials, Members of the Diet, business leaders, and U.S. Embassy officials. For brevity, this report deals primarily with those topics discussed in Japan even though other topics also may be of interest to the Congress. For additional information and analysis, see other CRS products on Japan.²

Introduction

Japan currently is a mixture of incongruities. It has some of the largest banks in the world, but total credit in the economy is declining as banks struggle to whittle down an accumulation of more than \$400 billion in nonperforming loans. It is the second largest single economy in the world with world-class corporations, but it is just beginning to recover from its third recession in a decade. The talk in Japan is of hard times and a real estate bust, but streets are teeming with shoppers, and, in Tokyo, building cranes perch atop rising skyscrapers.³ The government has enacted legislation that allowed the country to send its navy in support of the Afghan war effort outside the defense of its territory for the first time since World War II, but at the same time Japan's military still is constrained by its U.S.-imposed anti-war constitution. Prime Minister Koizumi had enjoyed sky-high approval ratings, only to see them plummet over the firing of his Foreign Minister in what one government official described as a "children's spat" and then see them rise again as he visited North Korea and received an unexpectedly positive response on issues of concern to Japan. His much anticipated economic reforms have scarcely materialized, but in October 2002 he shuffled his cabinet to make it more reformist minded.

¹ This congressional staff trip was sponsored by the Washington-based U.S.-Asia Institute and Japan's Ministry of Foreign Affairs. Since the meetings were frank and informal, quotations in this report identify sources only by affiliation and not by name.

² CRS Issue Brief IB97004, *Japan-U.S. Relations: Issues for the 107th Congress*, coordinated by Richard P. Cronin, and CRS Issue Brief IB97015, *U.S.-Japan Economic Ties: Status and Outlook*, by William H. Cooper.

³ Much of this construction is actually a gamble by the Mori Building Company to build high-rise office and condominium towers with the intent of renting to foreigners and business executives who no longer want to cope with long commutes on crowded trains. As President Mori of the company explained, Tokyo is "horizontally congested and vertically vacant."

Japan is a concern to the Congress because its national interests and societal values overlap considerably with those of the United States despite some friction in trade, whaling, the environment, and agricultural policy. Next to the European Union and Canada, the United States generally can count on Japan for cooperation and support both bilaterally and in international fora. The large size and influence of Japan's economy, particularly the risk of global financial turmoil stemming from its poor economic conditions, the fluctuating value of its yen, its huge trade surplus with the United States, and the critical flow of billions of dollars of Japanese capital into foreign markets make Japan's economic performance a global concern. Japan also plays a key role in U.S. security policy in Asia, including the hosting of American bases and cooperation in the anti-terror campaign.

In terms of policies, the United States has been visibly articulating its concerns and, in cases, recommending specific policy actions, partly to provide some outside pressure on the Koizumi government and partly to help overcome resistance by vested interests and the Bank of Japan. Specifically, the United States has been recommending that Japan: (1) stabilize its financial system and avoid a financial panic that could add fuel to mounting concerns over financial problems in Argentina, Brazil, and other Latin American nations; (2) clean up the bad-loan problem among its banks; (3) continue to open domestic markets, particularly in financial services, in accord with its World Trade Organization and other obligations (regardless of the threat to Japanese industries); (4) not adopt exchange rate policies that would unduly weaken the yen and harm U.S. business interests, (5) continue support of the war on terrorism, (6) take a larger security role in world affairs while avoiding conflicts with neighbors, and (7) continue to support U.S. forces in Japan.

Japan's concerns with the United States as articulated by Japanese officials to this staff delegation include future cooperation in the war on terrorism, U.S. protection of its steel industry,⁴ the state of the U.S. economic recovery and its implications for Japanese exports to the United States, reducing the footprint of U.S. forces on Okinawa (including the moving of training off Okinawa and returning land being used for bases to local jurisdiction), refining the Status of Forces Agreement, and future actions on missile defense.⁵ Japan also shares U.S. concerns about the future of China – China's economy and competition with Japan, military trends, and demographics. In addition, Japanese industry has complained that the process to obtain export licenses on items under U.S. export controls is too slow, in some cases arbitrary, and being handled by understaffed agencies. If the process is not improved, Japanese industry may turn to French and Russian suppliers. Japan is also unhappy with the space station and NASA's plan to scale it back. Japan is to receive 12% of the capacity for its use. Under a reduced scale plan, its allocation of astronaut slots could be cut severely.

A Foreign Ministry official stated that with respect to relations with the Bush Administration, Tokyo feels that it has not been adequately consulted on several

⁴ For details, see: CRS Report RL31107, *Steel Industry and Trade Issues*, by Stephen Cooney.

⁵ For details, see: CRS Report RL31337, *Japan-U.S. Cooperation on Ballistic Missile Defense: Issues and Prospects*, by Richard P. Cronin.

matters – particularly the U.S. rejection of the Kyoto Protocol. The lack of coordination, however, did not imply a lack of mutual understanding. Still, Japan would like for the United States to follow the “three noes” for the relationship: no surprises, no politicizing of issues, and no taking Japan for granted. The Japanese side also noted that, initially, the Bush Administration intended to raise the priority of relations with Japan relative to those with China and to rely less on “gaiatsu” or outside pressuring of Japan to take certain policy actions.

Japan’s Economic “Crisis”

Japan’s economy is beginning to recover from its third recession over the past decade. For Tokyo, this poor economic performance transcends the usual concerns over rising unemployment, business bankruptcies, and swelling national debt, because the country’s national prestige hangs on its economic success. Without a significant international military role, Japan has sought national purpose and recognition through economic might and “checkbook” diplomacy.⁶ If Japan does not restore health to its economy, many Japanese feel that the country is in danger of becoming a second- or third-rate power. The prolonged economic stagnation (along with other factors such as the aging of society) is destroying the people’s confidence in their corporate system, causing them to oversave (thereby worsening the recession), and eroding their confidence in the ability of their leaders to solve the nation’s ills.

Some indicators of the severity of economic conditions in Japan include the rate of unemployment at 5.4% in August 2002, up from 3.2% in 1995. This does not include vast hidden unemployment in businesses that have retained surplus workers or discouraged unemployed workers who have stopped looking for a job. Business bankruptcies in 2001 reached 19,441 cases (up from 15,046 cases in 1995) and were expected to exceed 20,000 in 2002. Of the bankruptcies in 2001, 30% were in construction, 18% in manufacturing, and 33% in wholesale and retail trade. Between 1995 and 2001, total loans and discounts of banks dropped 12% (from ¥512,747 billion in 1995 to ¥451,281 billion at the end of 2001).⁷ Perhaps the most serious problem in Japan is a result of the others – deflation. Consumer prices have fallen in four of the past seven years. Real estate and stock prices also have fallen half or more from their peaks at the beginning of the 1990s. Falling prices have resulted in lower rates of consumption, less investment, higher savings, and have contributed to the non-performing loan problem.

During the 1990s and through 2001, Japan grew at an average of 1.6%, down from the average of 3.9% in the 1980s. If Japan had continued to grow at 3.9% in the 1990s and through 2001, its real gross domestic product would have been 30.4% higher at the end of 2001 than it actually was. In other words, the “lost decade of the

⁶ In multilateral military campaigns, such as the 1991 Gulf War, Japan has provided money instead of troops or aircraft. It also has used economic assistance to help accomplish some of its foreign policy goals.

⁷ Japan Statistical Agency [<http://www.stat.go.jp/english/data/geppou/index.htm#k>].

1990s” and its continuation has cost the Japanese economy as much as ¥161 trillion (using 1995 prices) or about \$1.3 trillion dollars – almost as much as the gross domestic product of Brazil, France, or Italy.

Japanese government officials insist that the country has no banking or financial crisis. They admit that a short-run problem exists but are confident that in the long run the economy will be all right. However, in the short-run, if the economy worsens to the point where a series of large bankruptcies occurs causing the exchange value of the yen to plummet and a risk premium to be added to interest charges for large Japanese borrowers, a Japanese financial crisis could develop that could spread to other countries in the region.

Visitors to Japan, however, look around and ask just where the recession is. There are few visible signs of it. People are shopping; traffic is congested, and new stores continue to be opened. The severity of the economic problem does not meet the eye. As one Japanese official put it, there is a huge hole in the keel of ship Japan, but the passengers are still sipping champagne while the ship is sinking. Japan needs to focus more on creating new patterns for success rather than finding ways to cushion failures. This official concluded that Japan needs to move away from a centrally managed economic system to competitive diversity within the economy.

Society at large also seems fairly complacent about the country’s economic conditions. While there is considerable media coverage and discussion, there is no sense of crisis at the educated level of the population. People are depending on the government to solve the problem. There is no serious public debate and no apparent sense of urgency.

Poor economic conditions also have not deterred American companies from operating in Japan. Most major U.S. companies have subsidiaries or joint ventures there. When asked why they are in Japan and not in countries such as China, American executives in Japan replied that 75% of the action and revenues for companies in Asia is in Japan. It makes more sense to locate there than in other Asian countries, although most also have subsidiaries in those markets. If a company is not in Japan, it is not a major player. At one time, American multinational corporations thought that their survival depended on how well they could compete with Japanese businesses at home. Now that Japan is less an economic threat, there is less emphasis on that strategy. Now companies are in Japan because it is the second largest market in the world, contains a huge amount of pent-up demand in the form of household savings, has opened doors to markets because of trade liberalization, and is the center for development of much high-technology, particularly in consumer electronics.

Japan’s economy faces three basic problems. The first is the legacy of the bursting of the economic bubble in 1989 that includes a large accumulation of nonperforming bank loans and declining real estate and stock values. The second is the current global recession, a cyclical problem resulting from the worldwide downturn in 2001 exacerbated by the September 11 terrorist attacks on New York and the Pentagon, rising pessimism in society, and ineffective monetary and fiscal policies. The third is related to globalization, including the inability of industries to compete with imports under a more liberalized trading regime and the end of the

industrial catching-up process in which Japan could grow faster than the more advanced industrial nations by merely closing the technological gap.

Burst of the Asset Bubble. During the latter half of the 1980s, Japan's monetary authorities flooded the market with liquidity (money) in order to enable businesses to cope with the rising value of the yen. Businesses did invest in new capital equipment to become more competitive in international markets, but the excess liquidity also found its way into speculation in Japan's stock market, in real estate ventures, and in foreign investments. At that time, the market value of both land and equities was rising so fast that investors and speculators could hardly miss making huge profits from capital gains. The larger mistake for them, it appeared at the time, was not to borrow and make speculative investments and consequently not be positioned to reap returns from rising asset values. Banks considered most loans with real estate as collateral as being unquestionably secure.

When Japan's economic bubble burst in 1989 causing stock and land prices to plummet, the value of collateral underlying many loans dropped below the value of their loan principal. Commercial real estate ventures, especially office buildings, also became unprofitable as rents fell and vacancies rose. As the economy slowed, companies faced excess capacity, bloated inventories, and lower profits. As more loans turned sour, more of the underlying collateral had to be sold at "bargain" prices. Commercial land values in the six major metropolitan areas peaked in 1991 and by 2000 had fallen by 80%.

Japan's Nikkei stock market average peaked in 1989 at 40,000 and subsequently had dropped by more than two-thirds to roughly 12,000 by August 2001. It sagged even further in early 2002 before recovering slightly to 11,000 by April 1, 2002 as the fiscal year ended, but then dropped to around 9000 in September. As one business executive in Japan stated, the country suffers from "rational inexuberance" in which investor attitudes toward its stock markets are extremely pessimistic – but for rational reasons. As a result of the dismal performance of Japan's stock market, unrealized capital gains on holdings of stock by major banks which stood at ¥49.1 trillion (\$355 billion) in 1989⁸ had dropped to approximately ¥5 trillion (\$42 billion) in 2001. Since banks now must report their stock holdings at market (rather than historical) value, some banks face huge capital losses on their shareholdings. (Those banks that purchased stocks whose prices have subsequently fallen had been able to value those stocks as part of their capital at their higher purchase prices rather than lower current market values.)

A problem with Japan is that its protective economic system has not let companies go bankrupt as financial conditions have deteriorated for fear of rising unemployment and because of existing ties among companies and banks. The process has gone so far that some have called Japan the "zombie economy" because so many businesses remain alive that should have died long ago.⁹

⁸ J.P. Morgan Securities Asia. Japan's Bank Problem is About to See Policy Action. Economic Research Note. March 2, 2001.

⁹ Powell, Bill. We're Not Turning Japanese. A Burst Stock Bubble. A Torpid Recovery. A (continued...)

Global Recession. Following the terrorist attacks on September 11, 2001, an already weak international economy was weakened further. The world went through its first synchronized global recession in a quarter-century. Global growth was 1.4% for 2001 – down considerably from 4% in 2000. (For the world, an annual growth rate of less than 2% is considered to be a recession.) For a struggling Japanese economy already in recession and relying on exports to lead it toward recovery, September 11 was a stinging blow. The little recovery that had been occurring was attributable primarily to growth in net exports. A slide in the value of the dollar because of the attacks, meant that Japanese exporters had to sell their products with a higher-valued yen. Japanese stock market values, moreover, have dropped in tandem with those on Wall Street.

Globalization. The third problem for Japan's economy is that globalization has finally hit the country's manufacturing sector. It is undergoing wrenching change caused partly by increased competitive challenges from abroad. The Japanese government has long succeeded in protecting certain of its producers from international competition. Even companies, such as Toyota Motors and Nippon Steel that have become multinational, still enjoy a relatively insulated market at home in which competition is primarily among Japanese companies and not with foreign competitors. Now, however, Japanese industries without significant export sales or import competition (particularly services and agriculture) face increased competition from abroad. In many cases, Japanese companies, themselves, have moved their production facilities to neighboring countries and are targeting the home market with products made to Japanese quality standards and under familiar brand names. In the case of food imports from China, prices are so low that, in April 2001, the Japanese government imposed curbs on imports of shiitake mushrooms, leeks, and rushes, and China retaliated by levying punitive tariffs on the import of Japanese-made automobiles, mobile phones, and washing machines. Eventually, the two nations took a managed- trade solution of export restraints by China.

The net result of this increased competition from abroad is that when Japanese companies invest in new plant and equipment, much of it is going to other markets instead of into the domestic economy. Japan's automobile makers, for example, have invested more than \$17 billion in production facilities in the United States which by 2003 are to employ 47,010 workers working in plants with a capacity to produce nearly 2.5 million units.¹⁰ Nissan Motors recently announced it would follow Toyota and Honda into the Chinese market by investing \$1.03 billion in an existing Chinese automaker to produce cars and trucks.¹¹ While these facilities contribute to overall corporate profits, they are at the heart of the so-called hollowing out of Japan's

⁹ (...continued)

Whiff of Deflation. Is Our Economy Borrowing a Page from Japan? Absolutely Not. *Fortune*, September 30, 2002.

¹⁰ Japan Automobile Manufacturers Association. *Japan's Automobile Manufacturers – Global Companies in a Global Industry: Moving Forward with Cutting-Edge Technology*. Tokyo, JAMA, 2001.

¹¹ Zaub, Todd. Nissan to Make Big China Push – Firm to Invest \$1.03 Billion To Partner With Dongfeng In Ambitious Auto Venture. *Asian Wall Street Journal*, September 20, 2002, pp. A.3

manufacturing industries.¹² Not only is manufacturing capacity in Japan not increasing (from 1995, down 6% in February 2002), but capacity utilization has remained low (down 10% from 1995).

A further complication is that Japan's industries reflect a dualism generated partly by the degree to which they have been exposed to foreign competition. On the one hand, there are globally competitive companies, such as Sony and Nikon, who can compete with the best in world markets. On the other hand, there are companies in sectors that have been relatively isolated from global competition and often have been protected and heavily regulated. These include retail stores and financial services, which now are considered to be a drag on the economy – an element manifested in the country's nonperforming loans.

Furthermore, Japan's industrial policy, in most cases, has outlived its usefulness. When Japanese industries were catching up with those in the United States and Europe, a small group of the best and brightest in the government could justifiably lead the economy. The goal was clear, and the means to attain the goal was through government leadership and guidance. By the 1990s, however, the old system did not work any more. It actually hindered economic growth because of social norms and vested interests that had developed. In particular, social norms of groupism and a paternalistic corporate system in which individualism was frowned upon proved a problem in the new, fast moving, world in which industries are at the cutting edge and not closing the technology gap. Vested interests in industries such as construction, moreover, came to expect lucrative government contracts and wielded disproportionate political power.

Nonperforming Loans

The nonperforming loans (NPLs) held by Japan's financial sector total at least \$417.7 billion despite a decade of government programs to strengthen Japanese banks and private efforts to clean up the financial mess. This huge problem with private debt is causing credit to contract, monetary policy to be less effective, and contributes to the ongoing recession. Despite Bank of Japan interest rates of less than 1%, small- and medium-sized businesses in Japan face relatively high interest charges and a reluctance on the part of banks to lend them funds. Total bank credit has been declining. Japanese banks also have been reducing their lending in international markets, particularly in Southeast Asia.

As of March 2002, deposit taking financial institutions in Japan held an official total of ¥53.0 trillion (\$417.7 billion) in nonperforming (risk management) loans (up from ¥42.4 trillion in March 2000). Of the ¥53.0 trillion, banks held ¥43.2 trillion (\$330.9 billion) and cooperatives the rest. The nonperforming loans were categorized as those to borrowers in legal bankruptcy (¥4.5 trillion), loans in arrears

¹² Japanese investment in China, however, still is problematic. One business executive in Japan pointed out that for every two companies that go into China, two or three come out. They usually have been victimized by the Chinese government or have had their intellectual property stolen.

by 3 months or more (¥29.2 trillion), and restructured loans (¥19.4 trillion).¹³ The nonperforming loans account for 8.7% of total loans (8.9% for banks). These official figures, however, are thought to be understated. If one includes problem loans that might go sour if the economy goes into a prolonged recession, the total could be as high as ¥140.9 trillion (\$1.13 trillion) or nearly three times as much.¹⁴ Experience with firms declaring bankruptcy indicates that only about 30% of their bank loans had been listed as nonperforming, yet they became insolvent.

For most Japanese banks, only extensive government efforts and financing of bank recapitalization packages have kept them from bankruptcy or severe punishment by stock and lending markets. Even with government intervention, Fitch (an international rating agency) rates the intrinsic strength of individual Japanese banks as D or D/E (the bottom of the scale), although Fitch gives ratings mostly of A or A- on long-term debt for major Japanese banks. This is based on the theory that the banks' long-term debt instruments are of relatively higher quality than the issuing banks because the Japanese government would intervene to support them if necessary.¹⁵ The poor condition of Japanese banks did cause a "crisis" in 1997-98 when they had to pay a premium of as much as 0.7 percentage points over international bank borrowing rates to compensate lenders for their increased risk.

Over the 1990s, the Japanese government announced various programs and measures to resolve the problem of nonperforming bank loans. This included ¥1.8 trillion (\$13.75 billion) in public funds injected into 21 major banks in 1998 and ¥7.5 trillion (\$62.5 billion) in public funds that included ¥5.6 trillion (\$46.7 billion) allocated to be transferred to the top tier of Japanese banks through the sale in 1999 of new preferred bank shares to a government-run organization.¹⁶

The government, furthermore, has replenished funds in its woefully undercapitalized deposit insurance fund and nationalized two banks before selling them to private investors (the defunct Long-Term Credit Bank of Japan was bought from the government by the New York-based Ripplewood Holdings). It also has tightened accounting, auditing, and reporting standards. For much of the 1990s, however, the hope of the government was that if it could keep banks operating and the stock market could recover, bank profits from operations and capital gains from equity holdings could finance the disposal of bad loans. Despite billions of dollars in write-offs, however, nonperforming loans are appearing as fast as they are being taken off the books. As shown in Figure 1, between FY1992 and FY2001 (ending in March 2002), Japan's banks had written off a cumulative total of ¥31.3 trillion

¹³ Japan. Financial Services Agency. *The Status of Risk Management Loans of All Deposit-taking Financial Institutions* (as of the end of March 2002). August 2, 2002.

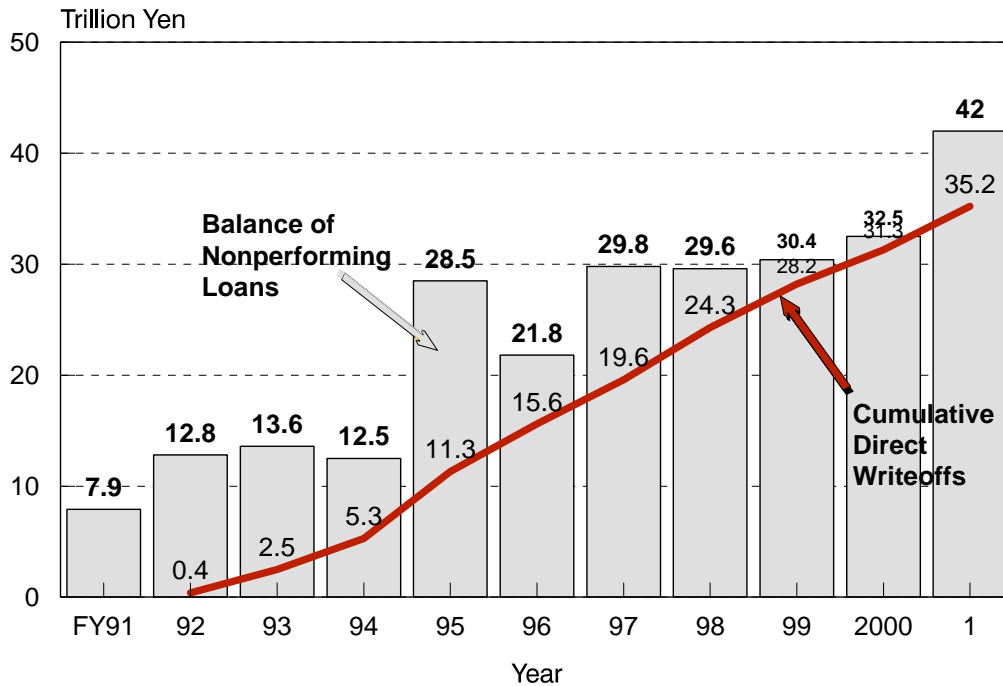
¹⁴ *Japan Digest*, August 3, 2001. P. 2.

¹⁵ These are not debt ratings but rather an assessment of the intrinsic strength of each bank assuming no governmental or other external support. See: Fitch IBCA on Internet at [<http://www.fitchratings.com/corporate/index.cfm>].

¹⁶ For details, see: Choy, Jon. *Banks Go Hat In Hand to Tokyo*. *JEI Report*, March 19, 1999.

(approximately \$275 billion) in bad loans, but new ones have appeared so fast that the total for bad loans has kept increasing.

Figure 1. Japanese Bank Balance of Nonperforming Loans and Cumulative Direct Writeoffs by Banks, FY1991-2001



Note: Bankrupt loans, Past due loans, & (from 1995) Restuctured loans.
Source: Japan, Financial Services Agency

Koizumi Government Economic Policies

Nonperforming Loans. In June 2001, the Koizumi government declared that banks must dispose of loans to bankrupt and near-bankrupt borrowers within two years and remove newly emerging nonperforming loans within three years of such classification – even at the cost of 100,000 to 200,000 jobs in troubled companies.¹⁷ Given Prime Minister Koizumi’s popularity rating at the time of over 80%, the hope was that he would succeed in pushing through reforms that until then had been stymied by powerful interest groups. Entrenched interests both within Koizumi’s Liberal Democratic Party (LDP) and among businesses, however, succeeded in reducing the scope of the reforms considerably. Eventually, the Prime Minister’s reform program turned into an anti-deflation plan as concerns about recession and deflation came to outweigh potential gains from reform. When the Koizumi government finally announced its antideflation plan on February 27, 2002, it

¹⁷ Dvorak, Phred and Peter Landers. Japan Weighs Stiff Measures for Economy. *The Wall Street Journal*, June 22, 2001. P. A11.

contained little in the way of concrete initiatives and generally disappointed markets and analysts.¹⁸

Economic policymakers, however, realize the economic situation has become so dire that if no visible progress occurs, market forces may accomplish what policy will not do. The international financial market may punish Japanese banks and companies. In the words of a private sector economist (referring to Argentina's financial crisis), "today's Argentina could be tomorrow's Japan." The conventional wisdom in Japan, however, is that since the major part of Japanese government debt is being held by Japanese citizens, there is no risk of capital flight as occurred in Argentina. But the situation in Japan is potentially precarious. Already, many Japanese private investors and depositors are moving out of yen denominated assets into foreign currency assets. The absolute amounts are not large yet, but the rate of increase is substantial. Interest rates in Japan, moreover, are so low that banks find it difficult to generate profits from yen denominated assets. At some point, they will have to diversify their holdings.

In a move that reflects the near desperation in Japan to resolve the banking "crisis," on September 18, 2002, the Bank of Japan announced that it would consider directly purchasing stock shares held by more than a dozen Japanese banks to shield them from latent losses on their shareholdings. The shares would be purchased directly from the banks and not through stock exchanges.¹⁹ The problem for Japan's banks is that they now have to value their stockholdings for reporting purposes at market prices. Just as these new reporting requirements were being implemented at the end of September, the Nikkei stock average dropped to the 9000 to 9300 level, a 19-year low and a quarter of the peak levels reached during the late 1980s. Japan's major banks, therefore, are expected to incur trillions of yen in new paper losses. This could threaten the capital adequacy of the banks and compel them to further curtail their loans to the struggling business community.

On September 30, Prime Minister Koizumi reshuffled his cabinet to enhance the authority of reformist Heizo Takenaka who was appointed to an additional State Minister post – for Financial Services as well as Economic and Fiscal Policy. Takenaka reportedly stated that he intended to tackle the bad loans with three principles: coming clean on the real nature of bank assets and outstanding loans, using more rigorous methods to appraise the net worth of banks, and enhancing bank profitability through better corporate governance. Koizumi also issued a policy statement that he would take policies to remove the uncertainty that permeates the Japanese economy, strive to overcome deflation, and conclude the disposal of nonperforming loans in FY2004.²⁰

¹⁸ Dvorak, Phred. Top Bush Adviser Criticizes Japan's Economic Measures – Aide says Antideflation Plan Will Likely Do Little to Stimulate Recovery. *Wall Street Journal*, March 20, 2002. P. A18.

¹⁹ BOJ Eyes Directly Purchasing Shares Held by Banks. Japan Economic Newswire via Dow Jones. September 18, 2002.

²⁰ Japan. Office of the Prime Minister. Statement by Prime Minister Junichiro Koizumi on the Occasion of the Cabinet Reshuffle. September 30, 2002. Analysis/Reshuffle Puts (continued...)

Inflation Targeting. Several economic policy analysts have recommended that Japan adopt an inflationary monetary policy. The theory behind this is that deflation is a macroeconomic condition being caused primarily by the Bank of Japan's monetary policy. Proponents of this approach assert that if the Bank of Japan would announce a target inflation rate, it would help reverse the slide in real estate and stock prices, improve the rate of return on capital investments, and spur consumption. In February 2002, however, Bank of Japan officials stated that they were considering inflation targeting but had no intention of introducing it at the time. The Bank's position was that deflation cannot be reversed by conventional monetary policy. (The Bank's discount rate of interest has been 0.1% since September 2001, while the short-term prime lending rate of private banks has been 1.375% since the end of 2000.) The bank also does not want to reduce pressure on the government to carry out reforms by adopting what they consider to be risky monetary policies. Economic analysts in Japan point out that an inflation target will not necessarily induce people to spend more. In its September 2002 *World Economic Outlook*, however, the International Monetary Fund urged Japan to adopt a more aggressive monetary stimulus to support economic activity. This monetary policy would include a public commitment to end deflation in no more than 12–18 months and further quantitative easing.²¹

Yen Depreciation. Another policy that the government has pursued is yen depreciation. This bolsters Japan's exports and stimulates business activity. Deliberately intervening to weaken the yen, however, can be a double-edged sword. While buying dollars and selling yen may have a temporary depressing effect on the yen, whether it will last is another question. Once intervention is ceased, currencies usually return to their former levels. Also, the process cannot always be managed. If Japanese government actions trigger a stampede out of yen assets, the drop in the value of the yen may overshoot and take considerable resources to correct. In 2002, when the Japanese government engaged in what it called "curbing the strengthening of the yen," the strategy was found to be largely ineffective and analogous to "spitting into the wind." Unless it was done on a coordinated and sustained basis with other nations, it had little long-term effect.²² Still, net exports – resulting partly from the weak yen – remains about the only bright spot in Japan's macroeconomy. A Ministry of Finance official, however, stated that he did not think that a weak yen was a substitute for structural reform.

Trade Policy. Japan runs a surplus in its balance of trade with the world that includes an \$80 billion surplus with the United States. Despite this large trade surplus, in recent years there have been few complaints from trading partners. Even in Tokyo, international trade issues are overshadowed by domestic economic problems. As an indicator of how extensively Japan's policy establishment has

²⁰ (...continued)

Economy First. *Daily Yomiuri On-Line*, October 1, 2002.

²¹ International Monetary Fund. *World Economic Outlook*, September 2002. On Internet at: [<http://www.imf.org/external/pubs/ft/weo/2002/02/index.htm>].

²² Mano, Teruhiko. Fluctuations in the Foreign Exchange Market and the Japan-U.S. Economic Relationship, *Japan Economic Currents*, August 2002, pp. 1-4.

turned from international trade issues to the domestic economy, in a briefing of the congressional staff delegation by the Ministry of Economy, Trade, and Industry (METI), all attention was on the economy. Trade policy was not even mentioned until the American side brought it up. When asked why there had been no discussion of trade issues, the METI officials said that after the reorganization of the cabinet departments and the change in their name from MITI (Ministry of International Trade and Industry) to METI, they hold major responsibility for the operation of the economy as well as international trade. While traditionally they have focused on specific industries and companies, their new portfolio includes monitoring and providing policy input on macroeconomic issues formerly the exclusive purview of the Finance Ministry or Bank of Japan. METI's new approach, they claim, no longer relies heavily on industrial policies, such as government assistance and protection of Japan's industries that so often became points of contention with the United States. A few trade issues, such as steel exports, still command attention, but they are considerably less politicized and usually are resolved through recourse to the World Trade Organization's dispute settlement mechanism.

U.S. embassy officials in Japan also noted that trade is less a problem now than in the past.²³ The commercial staff there tend to work more at the company level in assisting U.S. industries to enter the market than in resolving trade problems. In their view, Japan is now more open and entrepreneurial, and many local companies are searching for new product lines and possible foreign business partners. Opportunities exist, in particular, in information technology (e-business, e-government, and equipment sales), "silver services" (catering to an aging population), health care (medical equipment, pharmaceuticals, and medical supplies), and environmentally related equipment (recycling). The message from the embassy was for U.S. companies not to write off Japan.

With respect to the new round of multilateral trade negotiations under the World Trade Organization (WTO), American business executives noted that it is unlikely that Japan will willingly open its agricultural sector to imports. Once a WTO agreement is in place, however, the agreement becomes an effective catalyst for change within Japan. If the WTO requires Japan to change its domestic regulations, it usually will do so. During the negotiation phase, however, resistance in Japan can be strong and usually continues until further resistance becomes futile. Then the tactic turns toward salvaging protection in one form or another, such as a long phase-in period or trading off protection on one commodity for reducing it in another.

A strategy Japan has been pursuing is to seek closer trading arrangements with certain of its trading partners. In February 2002, Japan signed the Japan-Singapore Economic Agreement for a New Age Partnership. This is a restricted free-trade agreement with Singapore that covers most products traded between the two countries except for agricultural commodities. The country is considering additional free trade agreements with ASEAN, South Korea, Mexico, and Australia.

²³ For a review of trade problems with Japan, see: U.S. Trade Representative. *2002 National Trade Estimate Report on Foreign Trade Barriers*. Chapter on Japan. On Internet at [<http://www.ustr.gov/reports/nte/2002/japan>]

U.S. Policy Options on Japan's Economy

The United States and Japan have been engaged in what is called the U.S.-Japan Economic Partnership for Growth, launched by President Bush and Prime Minister Koizumi at a Camp David summit on June 30, 2001. This Economic Partnership includes a Financial Dialogue which is to serve as a forum for the U.S. Department of the Treasury and Japan's Ministry of Finance and Japan's Financial Services Agency to exchange information and views on a range of key financial issues, including non-performing loans of Japanese banks.²⁴

In the spring of 2002, several U.S. policy analysts were arguing for the United States to put more pressure on the Koizumi government to take action to avoid a financial crisis. Edward Lincoln of the Brookings Institution and Clyde Prestowitz of the Economic Strategy Institute recommend that because Japan's economic condition is an "economic time bomb of potentially nuclear proportions ... now set for detonation" that "it is time for the U.S. to start thinking outside the box on Japan policy" and that the Bush administration publicly "make clear its loss of confidence in the LDP leadership while suggesting to Mr. Koizumi that he might best lead by resigning and precipitating a political realignment."²⁵ Adam Posen of the Institute for International Economics argues that a "more explicit policy of U.S. pressure is worth it for desired outcomes" and that "the United States has to decide from a foreign policy perspective to demand from the Koizumi government the economically and symbolically important step of a real bank cleanup."²⁶ Two analysts with the Heritage Foundation recommend that the United States "clearly communicate U.S. priorities to the Japanese government and people and provide unequivocal political support for efforts to enact reforms."²⁷

The question of how much visible pressure to put on Japan to pursue economic policies that are in its own interests has long vexed U.S. policymakers. In a consensus society that since World War II has taken its cues from the United States, outside pressure (*gaiatsu*) can galvanize public opinion and provide cover for Japanese policymakers who may be compelled to adopt necessary, but politically unpopular, measures. Too much pressure, however, can offend Japanese public sensibilities and open the United States to accusations that it is reaching too far into Japan's domestic affairs.

According to Japanese officials, the Clinton administration exerted considerable pressure on Japan to use fiscal policy to promote economic recovery. President George W. Bush, however, began his presidency by saying he would not tell Japan

²⁴ U.S. Trade Representative. Fact Sheet. The U.S.-Japan Economic Partnership for Growth. June 30, 2001.

²⁵ Lincoln, Edward J. and Clyde Prestowitz. Helping Koizumi Out of the Box, *The Asian Wall Street Journal*, April 05, 2002 .

²⁶ Posen, Adam S. The Looming Japanese Crisis. Institute for International Economics, International Economic Policy Briefs Number PB02-5. May 2002.

²⁷ Hwang, Balbina Y. and Brett D. Schaefer. Addressing the Looming Financial Crisis in Japan. The Heritage Foundation Backgrounder No. 1530, March 26, 2002.

what to do. At Prime Minister Koizumi's first summit meeting with Bush at Camp David in July 2001, after Bush gave Koizumi some advice on resolving Japan's banking problem, Koizumi reportedly told Bush, "I take what you say as advice, not pressure."

As Japan's economic situation has continued to deteriorate, however, the Bush administration has become more vocal in articulating its desires for Japan to move forward to rehabilitate its economy. In June 2002, the Chairman of the Council of Economic Advisors stated that an early tax cut in Japan will help to prop up the economy. He also called on the Bank of Japan to keep its easy monetary policy, for the government to implement reform measures steadily.²⁸

For Congress, policy options include holding hearings, considering resolutions, or otherwise raising the pressure on Japan to take action. Most of the specific issues, however, are being addressed by the Treasury, State, and Commerce departments and the U.S. Trade Representative in bilateral discussions that address items of their particular interest. The Federal Reserve coordinates policy with the Bank of Japan, and the White House works directly with the Koizumi administration. In the past, Congress has pressured Japan to resolve certain trade issues by considering legislation that would have restricted certain of Japan's exports, such as automobiles. Currently, however, there are no particular industries (except for steel which already is being protected) in which imports from Japan have become a political issue. Both sides, moreover, are referring contentious trade issues to the WTO.

What is happening at the present is that the U.S. side will occasionally offer advice and encouragement to Tokyo, but essentially, Japanese policymakers are being left to work out a solution by themselves. The government and the Bank of Japan continue to offer piecemeal solutions, but an aggressive fiscal stimulus is being constrained by the rising national debt, and the Bank of Japan seems unwilling to pump enough liquidity into the system to counter deflationary trends and restore business investment levels. A tax cut being considered by Prime Minister Koizumi and encouraged by the Bush Administration is meeting resistance from Japan's Ministry of Finance. The ministry continues to be concerned about the national debt (now 140% of GDP) and low ratings its bonds are receiving. Some obvious deregulatory measures, such as freeing up the housing market and inducing a housing boom, seem stymied by vested interests. (Japan's only good growth year in the 1990s was in 1996 induced partly by the rebuilding of houses and other buildings after the earthquake in Kobe and Osaka.) Currently, the policy path for the United States seems to be to continue to raise concerns with Tokyo, publicize adverse consequences of inaction, help Japan's policymakers overcome resistance by vested interests, and encourage the Koizumi administration and Bank of Japan to adopt aggressive and comprehensive policies.

One problem in Japan has been that market forces internal to Japan have not forced unprofitable companies into bankruptcy and reallocated resources away from unproductive enterprises. The lack of market discipline is keeping "zombie"

²⁸ Hubbard Sees Benefits of Early Tax Cut in Japan. Jiji Press English News Service. Tokyo, June 7, 2002.

corporations alive partly because banks and other businesses own about 60% of Japanese stocks. The incentive for these corporate stockholders is to avoid the pain, not allow borrowers to go bankrupt, and hope for a government bailout. This results in capital being retained in the least productive parts of the Japanese economy. This cannot be easily resolved, because corporate selling of equities serves to depress the stock market even more. This is one reason the Bank of Japan has announced that it will purchase stocks being held by certain banks in off-market transactions.

In essence, there is no clear policy initiative that will solve Japan's economic problems. Structural reform to allow greater latitude for market forces would help in the long run, but would likely increase unemployment and consumer confidence in the short run. The government, therefore, is left with little policy leeway except to pursue traditional monetary and fiscal policies along with a sprinkling of intervention and reform. The Koizumi administration has announced that it will unveil a new economic initiative in October 2002. This is likely to include a tax cut to spur investment and more action to rid banks of nonperforming loans.

Terrorism and Security Issues

Several of Japan's security and terrorism related issues have been of interest to the United States. These include Japan's efforts in support of the anti-terror campaign, the status of U.S. bases in Japan, burden sharing, revised defense cooperation guidelines, and cooperation on missile defense. The meetings in Japan that form the basis of this report, however, primarily covered Japan's counter-terrorism efforts discussed below.²⁹ This section primarily describes problems and actions based on information gathered in Japan and does not include policy options.

Response to September 11

The September 11 terrorist attacks on the World Trade Center destroyed the New York offices of numerous Japanese companies and killed 27 Japanese citizens. Japan's national television provided all-night coverage of the attacks, and the Japanese public, which had previously experienced the 1995 sarin poison gas attack in the Tokyo subway became even more wary of terrorist activities. This increased terrorist threat occurred at a time in the development of postwar Japan when the country was evaluating its security relationship with the United States and was attempting to redefine its role in international affairs.

As Japan considered its response to the call by the United States for cooperation in the war on terrorism, policymakers were determined to avoid the foreign policy failure of the Gulf War when Japan relied on "checkbook diplomacy" (a \$13 billion contribution to cover its share of costs of the war) to fulfill its responsibility but did not even have its name listed in the newspaper advertisements taken out by Kuwait

²⁹ For further analysis of security-related issues, see CRS Issue Brief, IB97004, *U.S. Relations: Issues for the 107th Congress*, coordinated by Richard P. Cronin, and CRS Report RL31337, *Japan-U.S. Cooperation on Ballistic Missile Defense: Issues and Prospects*, by Richard P. Cronin.

to thank those countries who contributed to the Gulf War effort (even minor participants, such as Peru, were listed). This time, Tokyo decided to “show its flag” subject to the constraints of its pacifist postwar constitution.

According to a Japanese official, in Japan, members of the older generation that experienced World War II generally dislike military power. The younger generation, however, tends to think more rationally about security policy. They view the new terrorist threat as a monster in the global community. They recognize that, for now, the country must act within the constraints of its constitution but believe that, in the future, the constitution may have to be revised. This, however, will take time as the general public will have to change its understanding of collective security.

On October 29, 2001, Japan’s parliament approved the Anti-Terrorism Special Measures Law to allow Japan’s Self-Defense Forces (SDF) to take part in limited operations assisting the U.S.-led anti-terrorism campaign. The new laws allowed the Japanese navy to operate in the Indian Ocean transporting nonlethal supplies, sharing intelligence, providing medical care, fuel and water, and other supplies to U.S. forces. By mid-September 2002, the 15 Japanese ships operating in the Indian Ocean reportedly had delivered some 48 million gallons (about 180,000 kiloliters) of fuel to American and British ships.³⁰ Previous laws had prohibited participation in overseas military operations unless Japan was threatened or attacked directly. The law did not allow the SDF to participate in combat operations, but it did permit the SDF to use weapons in self defense and in defense of others under its protection.

The activities carried out included airlifting supplies to Pakistan, transporting materiel between U.S. bases in Japan and to Guam, and sending two transport ships escorted by three non-Aegis-equipped destroyers and a minesweeper tender to the Indian Ocean to resupply U.S. ships. This was the first time since World War II that Japanese warships had left Japanese waters. A debate had occurred within Japan over whether or not to send Aegis-equipped destroyers with their air defense radar and fire control system (as reportedly requested by the Bush Administration). Japan’s political opposition argued that sending such warships would violate the nation’s constitutional ban on deploying offensive forces.

According to a Foreign Ministry official, despite suspicions by other Asian nations of a possible resurgence of militarism by Japan, the country did not encounter much opposition to its use of military forces in support of the Afghan campaign. Even China did not complain much, and complaints from other Asian nations were virtually nil.

Japan’s response to September 11 set a precedent for one contentious issue. For some time, Japanese pundits had been debating whether the Japan-U.S. military alliance required that it act in defense of the United States if the U.S. were attacked. The formal documents are asymmetrical in that they require the United States to defend Japan if attacked but not the other way around. The relatively quick response by Japan to September 11 indicated that, at least in this case, the answer was in the

³⁰ U.S. Top brass hails MSDF’s refueling of U.S. warships, Kyodo News Service, September, 13, 2002.

affirmative. The Prime Minister and Diet also were able to act relatively quickly on new legislation despite previously expressed fears that, in a crisis, policy gridlock would develop in Tokyo.

In January 2002, Japan also hosted an Afghan Reconstruction Conference of international aid donor nations. The conference brought pledges of assistance amounting to more than \$4.5 billion dollars over varying periods of time, including some \$1.8 billion dollars to be provided in 2002.

Iraq

In February 2002, some Japanese security experts expressed apprehension about expanding the war on terrorism to Iraq. They pointed out that Japan's anti-terror legislation applied only to the September 11 incident and was in accord with the U.N. Security Council Resolution 1368 which recognized the right of U.N. member states to self defense. The legislation, however, could apply to future actions in Yemen or Somalia if they were directly linked to the Al Qaeda. In the case of U.S. military actions in the Philippines (against the Abu Sayyaf), the United States did not ask Japan for support, so it did not become an issue.³¹ Japanese officials expressed particular concerns over Arabic reaction to a U.S.-led military campaign against Iraq in view of Japanese dependence on the Middle East for petroleum supplies.

New Terrorist Threats

Japan, moreover, has recognized that in view of the new terrorist threat, the nation faces several basic security issues. Its 51 nuclear power plants, for example, have been guarded by local police who typically are armed with a nightstick and whistle. Since many of these nuclear plants are located on ocean shores facing west toward the Sea of Japan and North Korea, they could become targets for attack by seaborne commandos.³² There already have been many breaches of security around nuclear plants – small boats and mini-submarines. On December 22, 2001, moreover, the Japanese Coast Guard pursued, exchanged fire with, and sank a suspected North Korean spy ship that had entered its exclusive economic zone. In later salvaging, divers recovered a ground-to-air missile and a rocket launcher from the area where the ship sank. Combined with North Korean testing of missiles that can reach targets in Japan, Tokyo has been acutely aware of the need to revamp its procedures to deal with emergency situations, armed invasions, large-scale terrorism, unidentified armed vessels, spies, or terror attacks in cyberspace.

On April 16, 2002, Prime Minister Koizumi submitted three bills to the Diet aimed at correcting these deficiencies. The bills are to provide the government with a framework to deal with “emergency situations,” modify the current Self-Defense

³¹ For details, see: CRS Report RL31265, *Abu Sayyaf: Target of Philippine-U.S. Anti-terrorism Cooperation*, by Larry A. Niksch.

³² Nuclear plant security is becoming increasingly important to Japan since nuclear power currently supplies a third of Japan's electricity and the industry is planning as many as 18 more nuclear power plants. Nuclear power also helps Japan in meeting its carbon dioxide emissions targets.

Forces Law to widen the permissible activities of the Self-Defense Forces, and enhance the crisis authority of the Prime Minister and the Security Council of Japan.³³ The bills generated considerable controversy, and Koizumi was able to secure their passage before the Diet recessed for the summer of 2002.

Japan's Military

Japan has been reorganizing its conventional military forces following the end of the Cold War. According to a Self Defense Forces official, the military budget has been running at about \$30.9 billion per year (\$40.4 billion in 2001 according to international sources³⁴) or 0.95% of GDP and 6% of the government budget. About 45% of the budget goes for personnel costs, 19% for equipment, 18% for training, 11% for support of U.S. forces, 3% for upkeep of facilities, and 2.7% for research and development. Japan ranks fifth in military expenditures behind the United States, China, Russia, and France.

North Korea

In a surprise to many experts on northeast Asian security, on August 30, 2002, Prime Minister Koizumi announced his September 17 summit in North Korea. The visit proved to be a huge success with North Korea admitting that it had abducted a dozen Japanese citizens, promising that those still alive would be able to return to Japan, stating that unauthorized incursions into Japanese waters by Korean ships would cease, extending the North Korean moratorium on missile launches in and after 2003, and opening the door for negotiations to normalize relations between the two countries.³⁵ This summit was even more surprising considering that in the February 2002 visit by this delegation, there was no mention of improving relations between North and South Korea or South Korean President Kim Dae Jung's "sunshine policy" – let alone normalization of relations between North Korea and Japan.

During meetings in Japan in February 2002, some experts expressed concern over a possible U.S. attack on North Korea (an axis-of-evil country) as a second phase of the U.S. anti-terror campaign. There was some speculation in Japan that the suspected North Korean ship that Japan sunk (or was scuttled) in Japan's exclusive

³³ Japan. Office of the Prime Minister. Statement by Chief Cabinet Secretary Yasuo Fukuda on Japan's Preparedness to Respond to National Emergencies, April 16, 2002. On Internet at [http://www.kantei.go.jp/foreign/tyokan/2002/0416danwa_e.html]. Yuki Tatsumi. Japan's Defense Debate Be Heard, 'Contingency-related' bills. *International Herald Tribune*, May 1, 2002.

³⁴ The International Institute for International Studies. *The Military Balance, 2001•2002*. London, Oxford University Press, 2002. P. 194.

³⁵ Struck, Doug. N. Korea Admits It Abducted Japanese, *Washington Post*, September 18, 2002. P. A1, A18. Japan. Office of the Prime Minister. Japan-DPRK Pyongyang Declaration, September 17, 2002. For additional information, see: CRS Report RS20526, *North Korea-Japan Relations: The Normalization Talks and the Compensation/reparations Issue*, by Mark E. Manyin or CRS Issue Brief IB98045, *Korea: U.S.-Korean Relations – Issues for Congress*, by Larry A. Niksch.

economic zone was sent as a result of the U.S. anti-terror campaign. Many in Japan seemed uncomfortable with the label placed on North Korea. In Japanese tradition and culture, there is no such direct name calling.

Within Japan, partly as a result of pressure by the United States to cut off funds for terrorists, Tokyo has taken action to halt the flow of money to North Korea. Unofficial Japanese funds to North Korea come from Japan's *chogin* (lit. Korean bank) credit unions which mainly serve the some 635,000 ethnic Koreans in Japan who are loyal to the North. The credit unions allegedly have funneled hundreds of millions of dollars to Pyongyang which some say may partly have been used to buy weapons. The irony of the situation is that the combination of funds being sent to North Korea and non-performing loans from Japan's sagging economy caused several of these credit unions to go bankrupt and the government to make payments under its guarantees to depositors.³⁶ North Korean community members now seem reluctant to deposit money in a *chogin*, so as of early 2002 the flow of currency from Japan to North Korea had virtually stopped. As part of the normalization of relations between Japan and North Korea, however, Japan is expected to make a payment to North Korea of as much as \$10 billion as an economic aid package.³⁷

China

From a Japanese point of view, there are two great powers in Asia: the United States and China. Other Asian nations stand between and among the big powers. The key to both economics and security in Asia lies in which direction China will move. Japan is watching how the United States proceeds in its relations with China, particularly with the war on terrorism and following the military aircraft collision incident in 2001.

In Japan, there are two basic views of China. The first is that China will continue to grow and develop and become the world's second largest country in terms of GNP by the mid-2000s. China will invest in its military, so it will be a large economic and military power that will put pressure on its neighbors. The second view is that communist rule in China will be unable to manage the economy. Local communities will become more independent of rule by Beijing. Businesses will become more independent as state-owned enterprises disappear or become privatized. China will become more like other market economies with its revenue base more and more dependent on its ability to tax rather than ownership of means of production. The large stake by the business community in stable trade and investment relationships could temper any aggressive actions by the Chinese military.

There is concern in Japan, moreover, that pressures are building in China for major change in the political system. This change can be either incremental and systematic or violent. No one knows how long it will take. Changing China's

³⁶ Simms, James. North Korea Adds to Japan Bank Crisis – Tokyo Finds Pyongyang-Linked Failed Credit Unions Are Costly to Clean Up. *Asian Wall Street Journal*, April 4, 2002.

³⁷ See: CRS Report RS20526. *North Korea-japan Relations: the Normalization Talks and the Compensation/reparations Issue*, by Mark E. Manyin.

political system, however, does not solve the problem of China as a strong hegemon in Asia.

A retired Japanese general stated that the rising power of China could be the largest military threat to Japan in the long term. (In 2001, China's defense budget was \$17.0 billion or 42% of Japan's budget.) He stated that if China were to try to intimidate Japan with ballistic missiles, the country would have to turn to some kind of missile defense. Also, Japan has 6,000 nautical miles of coast land which are difficult to protect with just its Maritime Self Defense Forces. Japan has to cooperate with the U.S. Seventh Fleet in its coastal defense. Another official stated that while China is not an immediate threat, it could become one in 10 to 20 years. Still, according to one official, Japan probably will not participate in a security arrangement that is overtly designed to oppose China.

Japan's approach to China has been to work within the framework of economics and trade and then progress to security in the next stage. In 2001, Japan incurred a deficit in its trade with China of \$26.6 billion (exports of \$31.7 billion and imports of \$58.3 billion). Despite this trade deficit, many in the Japanese business community do not see China as a threat. Virtually all large Japanese companies have subsidiaries or joint ventures there. The idea is to keep the home offices of the company along with research and marketing in Japan but to move the assembly operations to China. This is the "hollowing out" of the economy. If one Japanese business goes into China, other businesses in the industry rush to go there as well. Most view China as a great opportunity to build economic interdependence and possibly for Japan to escape from its economic stagnation.

Compared with investment in North America and Europe, however, Japanese direct investment in China is still relatively small. Between 1979 and 2001, Japan had invested a total of \$32.4 billion in China (\$4.3 billion in 2001). By comparison, in the year 2000 alone, Japan invested \$12.6 billion in North America and \$25.0 billion in Europe. A difference, however, is that investments in the industrialized regions of North America and Europe are primarily to serve those and neighboring markets. Although much of the Japanese investment in China also is to serve the local Chinese market, much is also for export to third country markets and to Japan. Still, the rapidly expanding Japanese presence in China holds important national security implications. Japanese industry is becoming embedded in China. A Japanese analyst observed that Japan, as a nation, has to put national security first. Businesses put profits first with minimal considerations of national security. Once the economies of China and Japan become more integrated, however, security issues should be easier to address.

In the opinion of one official, Japan will have to work toward an Asia free-trade area or it will be dominated by China. This official, in somewhat of an overstatement that nonetheless resonates in Japan, characterized the nation's difficulties in the economic realm as "facing either becoming the 51st American state or a colony of China."

Japanese officials also expressed concern over the change of leadership in China scheduled for late 2002 and early 2003. The question is which direction China will

go. Japanese officials have asked their Chinese counterparts, but Chinese officials also appear uncertain.

Taiwan

With respect to Taiwan, a Japanese policy analyst indicated that more than 50% of the Japanese population would have sympathies with Taiwan if the island were attacked by mainland China. What kind of support Japan would offer, however, is a different question. According to a military official, Japan's official position is that Taiwan is a part of mainland China. Japan will not intervene in a conflict over reunification, but if Japanese national interests are damaged by a conflict, the country would defend its national interests. Currently, approximately 30,000 Japanese citizens are in Taiwan. According to the Japanese SDF, in case of an attack on Taiwan by China, Japan would take action to defend its citizens. If China should close the sea lanes in the Straits of Taiwan, Japan would likely act to defend them if the United States did not, although it is presumed that the United States would do so. A foreign ministry official, however, pointed out that strategic ambiguity with respect to Taiwan has worked. Japan is committed to work with both Beijing and Taiwan to achieve a peaceful resolution of the situation. In his words, it is better to see the situation as it is rather than to have abrupt change.

In terms of a probable Russian response to an attack by the PRC on Taiwan, one Japanese official pointed out that Russia and China have disparate interests. Russia has recently moved closer to the United States and has no basic interests in Taiwan. Russia probably would not endorse the use of military means by China to resolve the Taiwan issue. Over Taiwan, therefore, separate approaches to China and Russia are necessary. Japan, incidentally, does not welcome the purchase of Russian military equipment by China.

Senkaku (Daioyu) Islands

With respect to the Senkaku Islands (a set of eight uninhabited islands in the East China Sea that currently are in dispute between China, Taiwan, and Japan), Japan's position is that the Senkakus are Japanese territory.³⁸ According to a Japanese official, if China were to attempt to take over the islands, Japan would exercise its rights of self defense to defend the territory. If the United States remained neutral in a fight between China and Japan over the islands, then the U.S.-Japan security relationship would be called into question.

³⁸ The islands are thought to have potential oil and gas deposits. China claims that Ming Dynasty fishing vessels frequented the islands. Japan claims that in January 1895, during the Sino-Japanese War, the Chinese Emperor agreed to cede the Senkakus to Japan. See CRS Report RL31183, *China's Maritime Territorial Claims: Implications for U.S. Interests*, by Kerry B. Dumbaugh (coordinator) David M. Ackerman, Richard P. Cronin, Shirley A. Kan, and Larry A. Niksch.

Theater Missile Defense

With respect to theater missile defense (TMD), Japanese officials indicated that Japan had joined with the United States in the research phase. This is not too controversial, but later phases of TMD may be quite contentious.³⁹ The general population of Japan does not seem to understand why TMD is necessary. The case has not yet been made with respect to its cost effectiveness, what kinds of missile threats exist, and how much TMD would be needed. Many experts and some politicians in the Diet view TMD as an effort by the United States to “make money” (by selling technology and equipment). The cost of TMD is huge. One Japanese official suggested that the United States send a team to brief the members of the Diet. Since Japan has no intelligence committee, Diet members do not get briefings on such secret matters. A member of the Diet in one meeting, however, indicated that he “stood by President Bush on TMD.”

Another question with respect to TMD is whether Taiwan would be allowed into the system. Certainly for the People’s Republic of China, it would not be acceptable to have joint control by the United States, Japan, and Taiwan of a TMD radar system. Japan’s Self Defense Forces also can be engaged only in the defense of Japan, but under the above TMD system, that would not be the case. If Japan were to deploy radar ships in the Sea of Japan and China were to launch missiles against Taiwan, then Japan would become a *defacto* protector of Taiwan. Such a situation would be difficult for Japan.

The Kyoto Protocol

The rejection of the Kyoto Protocol (to reduce emissions of six greenhouse gases) by the Bush Administration in March 2001 reverberated rather widely among the Japanese people.⁴⁰ In addition to the fact that the protocol was agreed to in Japan, the U.S. rejection was viewed as another example of American unilateralism. Some Japanese officials see their country as being caught between the Americans and Europeans but not being strong enough to do much as an independent actor. Actually, the issue in Japan with the Kyoto Protocol was not only the environment but concern about American unilateralism in view of Japan’s preference for multilateralism. This dichotomy affected Japanese public support for the war on terrorism. The Japanese government had to mollify public opposition to U.S. unilateralism when arguing for Japan’s support of the anti-terror campaign. Actually, many Japanese businesses also think that they cannot comply with all the provisions in the Kyoto Protocol. It would be more palatable to the Japanese government and business community, however, if the United States at least would accept the essence of the Protocol.

³⁹ See CRS Report RL31337, *Japan-U.S. Cooperation on Ballistic Missile Defense: Issues and Prospects*, by Richard P. Cronin. 32p.

⁴⁰ For further information, see CRS Report RL30692, *Global Climate Change: The Kyoto Protocol*, by Susan R. Fletcher, 12p.

Bush-Koizumi Summit

In February 2002, President Bush visited Japan for a summit meeting with Prime Minister Koizumi at the same time this congressional staff delegation was in Tokyo. For Bush, this was a “make-up” visit for the summit originally scheduled for November 2001 but postponed in the aftermath of the September 11 attacks. The purpose of the visit was to thank Japan for its support in the war on terrorism, provide support for the Prime Minister, and to encourage the government to take action to address its economic problems, particularly the disposal of nonperforming loans. According to Embassy officials, the visit was not complicated and did not result in a joint statement.

Baseball turned out to be a strong common interest which the two leaders discovered when President Bush picked up an autographed baseball that the Prime Minister had in his office. The Japanese side also was able to accommodate a request by the President to dine one evening in a typical Japanese restaurant. As a precaution, the Japanese side asked the chefs to substitute steak for raw fish on the menu. Both sides agreed that the two had established a friendly personal relationship – warmer than Prime Minister Koizumi enjoyed with fellow leaders of Asian nations or even with many members of his own party.

A highlight of the visit was President Bush’s address to a joint session of the Diet. The speech was punctuated by applause – a rarity for the solemn Japanese body. At one point in the speech, however, Bush mentioned Prime Minister Koizumi’s economic reforms and was taken aback when the statement was greeted with a ripple of laughter in the assemblage. White House staff first speculated that Communist Party members had planned to respond with laughter to express their disapproval of Koizumi’s inaction on promised reforms. However, as it turned out the simultaneous translation being broadcast to earphones was a sentence behind the actual delivery of the speech, and the laughter was in response to a humorous translation of Bush’s previous sentence and not about the reforms or the lack of them.

Conclusion

In summary, Japan is like a hobbled giant that is seeking to cast off some of the fetters that have kept it from assuming a more prominent and independent security role in world affairs. The war on terrorism has provided Tokyo with the opportunity to ease out from some of the constraints imposed by the pacifist attitudes of its people and its no-war constitution. Concurrently, Japan is viewing with some apprehension the rising economic and military challenge of China and the new terrorist threats.

Two recent indications of Japan’s effort to gain a more prominent position in world affairs are the greater visibility by its navy in the war on terrorism and Prime Minister Koizumi’s September 2002 visit to North Korea. For the first time since World War II, Japan’s Maritime Self Defense Forces are operating in a military campaign outside its territorial waters. The role is non-combative, but Japan’s Diet

has supported this wider military support activity despite its cost and some objections from inside Japan and mild protests from certain of its Asian neighbors.

Twenty-seven Japanese citizens were killed in the attacks on the World Trade Center in New York. This underlined the fact that Japan's businesses abroad as well as much of its infrastructure at home (such as its nuclear power plants) are vulnerable to terrorist attack. Tokyo is responding to these new threats with legislation to allow a greater role for its military and a more effective police force, but it still recognizes its role as subordinate to that of the United States in the global war on terrorism.

Prime Minister Koizumi's summit with North Korean leader Kim Jong Il seemed to indicate two new policy thrusts. The first is the willingness of Japan to undertake major diplomatic initiatives without prior concurrence by the United States. The second is to put its domestic interests ahead of any U.S. grand strategy. In particular, after the Bush Administration had labeled North Korea as one of the triad in the "Axis of Evil," Japan took a bold step in the opposite direction. The summit is leading to normalization of relations between the two countries, a payment of billions of dollars to North Korea in foreign aid, and a significant reduction in bilateral tensions. This summit indicated that despite Japan's close military relationship with the United States, it is willing to proceed on its own to resolve issues that it considers important.

Japan also is grappling with the rise of China. It is apparent that over the past two decades, China has increased its influence in Asia both through economic and military means. In many cases, this has come at the expense of Japan. Not only are Japanese manufacturers investing in China, but many of those investments appear to be zero sum in that China's gain is Japan's loss. The numbers are still not large, but they are growing, and the burgeoning manufacturing presence of China is adding to the pessimism in Japan over its own economic future. Added to this economic challenge from China is the uncertainty over the Chinese military and Beijing's threats to take Taiwan by force if necessary. Even though Japan's military budget is more than twice that of China, Japan's arsenal is confined to defensive weaponry, whereas China has developed considerable offensive capability. While Japan is reluctant to join a missile defense system aimed at China or to get drawn into a military conflict over Taiwan, its ties to the United States and its extensive investments and business presence in Taiwan could thrust it into unprecedented and uncomfortable situations.

For the United States, while the military relationship with Japan seems secure, the relationship is becoming more like that with other industrialized countries. The alliance is strong, but Japan does not want to be taken for granted, and Tokyo is more willing to pursue its own interests even if not on the same track as that of Washington.