



## What can European leaders learn from Koizumi?

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### Abstract

Following a long period of stagnation, Japan is growing again. The key to this success story is Koizumi's relentless focus on structural reform, with two objectives: breaking the structural trap of political constituencies defending old and unproductive economic sectors; and adopting a two-pronged macro-micro approach to make reform unavoidable. This paper argues that Europe should follow a similar strategy whereby financial market integration, and not the EU bureaucracy and grandiose political declarations, should become the main driving force of national economic reforms, pressuring liberalisation in goods and services markets and making labour market reforms unavoidable.

### Introduction

During discussions about the global economy in Tokyo in late 2005, the most typical comment went as follows: "The global economy is doing fine, the US and Japan are strong, Europe is the only weak area at the moment." That sentiment, to the ears of a European, gave much pause for thought. Wasn't Japan just a few years ago a lost case, an example of all the policy mistakes that a country can make, the country of the 'lost decade'? Wasn't Europe to become the most vibrant and dynamic economic area of the world by 2010? What happened to achieve this reversal of fortunes in just a couple of years, to see a dynamic Japanese economy that is again attracting foreign investment and that it is starting again to invest around the world? What happened to Europe to become the sick man of the world, the economy that does not manage to grow above a declining potential growth rate despite ultra-easy global liquidity conditions?

Apart from some assorted differential shocks, what has happened is that Japan has taken economic reform seriously and has had a political leadership that has been willing to take risks to make it happen.

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At the same time, Europe has lacked a serious commitment to reform. European leaders have recently taken the easy road of talking grandiosely about reforms to then linger and bicker and debate and finally deliver a much watered-down version of the original plan. By talking and not delivering, European leaders have generated 'reform inflation', devaluing the value of the concept of reform. In Japan, reform has had a positive impact on confidence while in Europe reform has become stigmatised among citizens. Europe needs a leader like Koizumi that can lead with a decisive reform agenda, with the proper sequence of actions and adequate delivery of promises, and who is willing to take political risks. We discuss below the process of Japanese reform and draw conclusions and lessons for European leaders.

### The sun rises again in Japan

The Japanese economy recently reached a key milestone with core consumer price inflation reaching 0.1% on a year-on-year basis in November 2005, the first positive reading in over two years. With inflation expected to continue climbing gradually, the Bank of Japan (BoJ) will soon declare the end of the deflationary period and that the economy is on track to end its policy of quantitative easing and shift to an interest-rate targeting regime.

Although the focus of markets and policy-makers is on the CPI, the reflation process extends to income and asset prices. The economic recovery is broad-based. Wages are rising alongside employment, contributing to the strongest labour income growth since the late 1990s. The improving labour market is anchored by strong business-sector performance. Corporate profits have expanded for three straight years, lifting margins to historical highs. Sales growth is the strongest since the mid-1990s. The

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Bank of Japan's Tankan survey shows that business confidence has risen to the highest levels since the early 1990s. Japan's gross domestic product could grow as much as 3% in 2006.

Stronger income growth is mirrored in a broad-based turn in asset prices. Stock prices have doubled from the lows of early 2003. Land prices have stabilised, with gains increasingly widespread in large cities. Rising asset prices have bolstered bank balance sheets. BoJ data show that bank loans are growing (adjusted for write-offs and securitisation) at an increasingly rapid rate, accompanied by a pickup in money supply growth.

After four years of stop-start growth, including a technical recession in 2004 recently wiped away by statistical revisions, it looks as if the Japanese economy really is on track for a sustainable recovery. In fact, Japan was the fastest-growing G7 country in late 2005.

Several benign factors have come together to produce this happy turn of economic events, including rising demand for Japanese exports. But mostly, Junichiro Koizumi, the prime minister, and Heizo Takenaka, the internal affairs minister, who spearheaded Japan's financial reforms and is now charged with privatising Japan Post, deserve credit. Koizumi's greatest legacy is in the field of politics. By fighting the September 2005 general election on the issue of post office privatisation – and winning a big victory – he made economic reform respectable.

More importantly, he shook up the ruling Liberal Democratic party. His victory accelerated the transformation of the LDP from a party run by powerful factions and beholden to conservative rural interests into a more modern and representative organisation. The one-party rule in Japan is rather deceiving. In fact, Koizumi has achieved a very important revolution in the Japanese system of politics. By reforming the postal system and resisting the calls from within the LDP to water down or even stop the reform, Koizumi killed the main source of financing of local and regional political factions – Japan Post manages about 30% of all household savings, and these funds were mainly used to finance inefficient and wasteful public investment projects. And killing is not a bad word to use: in fact, Koizumi enlisted a group of young reformist leaders to beat the old-time LDP candidates in the September elections, and this group of leaders was called 'the assassins'.

Koizumi achieved his economic revolution by adopting a two-pronged approach. On the one hand, he expressed a clear determination to reform the economy, at almost any cost, and subordinated cyclical policies to this objective. Fiscal tightening was postponed and monetary policy, although independent, contributed by adopting the restoration of inflation as its main objective. On the other hand, and to complement this 'macro' top-down approach, Koizumi laid the ground for a simultaneous 'micro' bottom-up approach, by making bank and corporate restructuring the centrepiece of its reform programme. By changing the incentives and objectives of

the financial sector – this was the key of his programme, not the reduction of non-performing loans which was a by-product of this strategy – Koizumi's strategy made economic reform unavoidable. The corporate sector was cut off from the traditional lines of politically-induced financing and had to reform or die. Thousands of zombie companies closed down and once all the dead wood had been eliminated and excess capacity removed, the economy was ready to start working again. It took more than 10 years for the Japanese authorities to realise that preserving the status quo was the road to perdition, that Japan had fallen into a structural trap,<sup>1</sup> which had to be broken in order to survive. But once they understood the problem they moved on to break the trap. The postal savings reform again exemplifies this, for it eliminates the distortions against private financial institutions – the Postal system does not pay deposit insurance premiums and enjoys tax free income - and should allow the relocation of capital towards more productive uses.

### What are the lessons for Europe?

The Japanese strategy for reform can be summarised in two main ideas:

- break the structural trap of political constituencies defending old and unproductive economic sectors;
- adopt a two-pronged macro-micro approach to make reform unavoidable.

In essence, it amounts to changing the incentive structure in the political and economic arenas. A review of the recent European experience suggests that Europe can certainly improve in these two areas.

The European approach to reform was, in fact, designed precisely to avoid the structural trap. By designing a European bureaucratic superstructure to oversee reform, European leaders wanted to avoid the short-termism typically associated with government agendas catering to special interests, and force long-term reform plans onto national governments. The process of European integration would make reform unavoidable: the European competition policy and the single market process were designed precisely to slowly but surely eliminate efficiencies in the European market. In addition, the creation of the European Central Bank and the adoption of the Stability and Growth Pact were meant to indicate that countries surrendered their national policy sovereignty in order to give priority to medium-term issues such as price stability and long-term fiscal solvency.

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<sup>1</sup> A country falls into a structural trap when the interplay of long-term economic development incentives, politics and demographics prevents an economy from efficiently reallocating capital from low-return to high-return uses. See Robert H. Dugger and Angel Ubide (2004), "Structural Traps, Politics and Monetary Policy", *International Finance*, 7:1, for a comprehensive discussion of structural traps and their implications for monetary policy.

This model worked for several years but, at some point in the late 1990s, the effectiveness of the anti-structural trap devices faded and some European leaders started to hide behind grandiose declarations and the blurring of discipline that the euro delivered to undertake a populist domestic agenda. The disregard for the Stability and Growth Pact in some large European countries during the late 1990s was, in hindsight, a clear leading indication of their future intentions. The lack of progress with the Lisbon Agenda, the rejection of the services directive and the refusal to reform the CAP are just confirmations of the lack of true reform spirit in Europe. And they reveal that Europe is still in a structural trap: old sectors – agriculture, old workers – still exert too strong an influence over national politics, and national leaders are trying to escape the ‘macro’ disciplinary devices that the EU imposes over them.

And here is where the second lesson from the Japanese experience is key. Even with a leader with a very strong commitment to reform, the dynamics of the electoral cycle imply that politically-driven reform is doomed to fail. A two-pronged approach, with micro reforms supporting the macro political pressure, is needed for a successful reform process. With this in mind, by focusing mainly on politically-driven labour market and welfare reforms, European leaders have got the sequencing of reforms wrong. Up to now, there have been plenty of labour market and social security reforms, some goods and services liberalisation, and little financial market integration. The sequence should have been precisely the opposite. Financial markets, and not the EU bureaucracy and grandiose political declarations, should have been the main driving force of national economic reforms, pressuring liberalisation in goods and services markets, which would finally make labour market reforms unavoidable.

Thus, in addition to adopting a clear political commitment to reform, the most important reform European leaders need to foster is to accelerate the integration of EU financial markets, both by accelerating the implementation of the Financial Services Action Plan and by adopting national legislation that eliminates the lingering inefficiencies – such as the anachronistic *Livret A* in France, or opening up the ownership of the savings banks in France, Germany and Spain to allow for cross-country mergers and more efficient integration of the European banking system. European consumers still pay too much for their banking services, and markets are not exerting enough discipline on the corporate sector, allowing inefficiencies to fester. Further, European consumers deserve to have access to an integrated mortgage market where fixed rate mortgages can easily and cheaply be refinanced. In this world of low inflation, low interest rates, low wage growth and high asset values, consumers deserve to be able to access the equity of their assets for current consumption. Europe’s potential growth rate would be lifted by these reforms, and the transmission mechanism of monetary policy

would be shortened and made considerably more powerful. In addition, these reforms will not dent consumption in the near term and will transmit a badly-needed positive message.

Next, European leaders must urgently complete the single market in services. Financial market pressure, combined with aggressive trade liberalisation, should make this completion unavoidable. European leaders have here a unique opportunity to show their reformist credentials and present a convincing case for market liberalisation. If, as the recent WTO Hong Kong summit showed, European leaders continue to use trade policies to preserve the appearance of the European landscape rather than to foster the efficiency of European markets, the credibility of their reform agenda will sink. The strong defence of the Common Agricultural Policy and the arguments during the discussion of the EU budget over who wins and who loses – rather than over what is in the interest of Europe – are clear signals that Europe is still in a structural trap.

Finally, in order to be able to accommodate the inflow of immigration needed to alleviate Europe’s demographic problem, the insiders/outside structure of European labour markets must be dismantled. The evidence shows that, regardless of the immigration policy model that is adopted, only countries that can provide adequate jobs for the immigrants and their children are successful in absorbing large waves of immigration. Thus, rather than adopting yet another type of flexible employment contract that will make the employment of the young and low skilled even more precarious, European leaders must face the unions and reduce the still rather high levels of job protection that the insiders enjoy in some countries. European leaders must move towards a welfare system that protects workers, not jobs. And this will be much easier if strong financial markets and integrated goods and services markets exert pressure on the social partners. Let’s not forget that Koizumi has cut the salaries of Japanese civil servants by over 40%, and that life-time employment has become the exception rather than the rule. Sacred cows can be killed.

### Conclusion

As the recent experience in Japan shows, this sequence of reforms, properly explained and cast in a positive message, could make the European horizon much brighter. Thanks to Koizumi, Japanese citizens understood that delaying reform is a recipe for failure, and gave him a strong political endorsement last September. Now Japan is booming again, and despite the rather negative fiscal and demographic outlook, Japanese citizens are optimistic about their future and Japanese investors are increasing their risk-taking again. All the recent calls in Europe for more national ownership of the reform programmes amount to this: to ask the European leaders to successfully execute their own plans. Where is the European Koizumi?

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