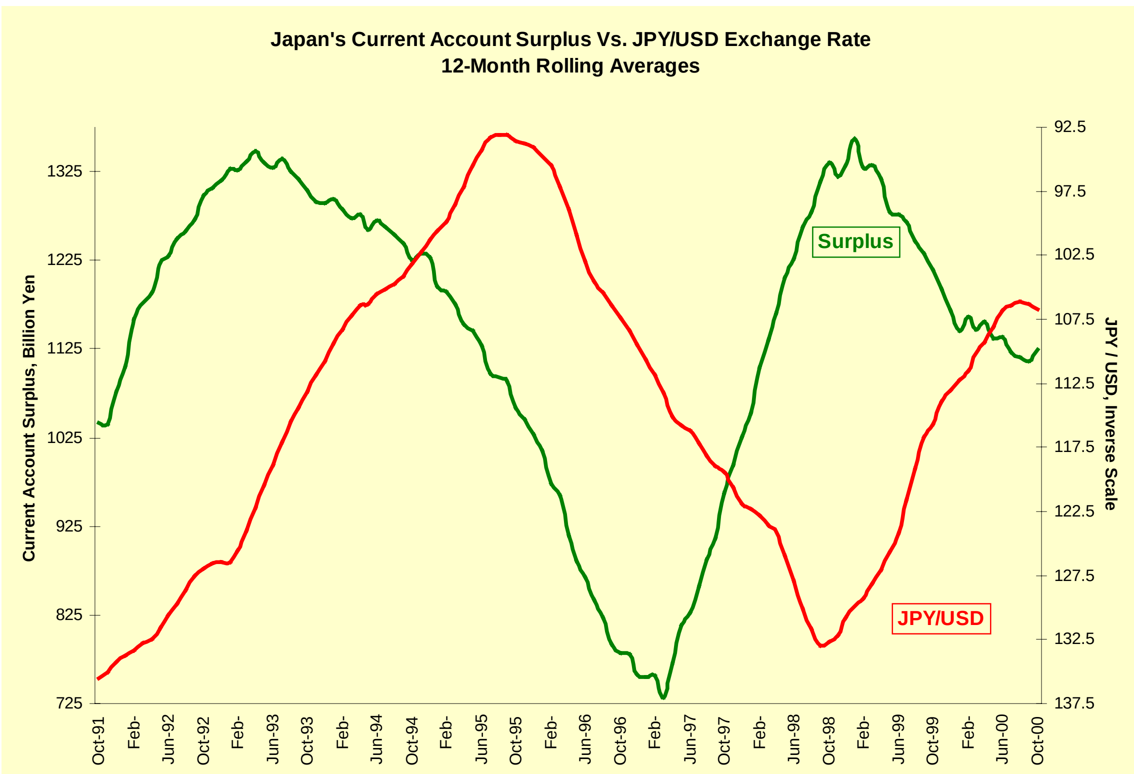
The Precious One Party System

Imagine the horror of living in a country filled with bickering and ethically challenged politicians. A country whose stock market is on the road to nowhere. Where, in a stunning rebuttal to Raymond Chandler, the game stays the same and so do the players. A country wherein the name "Kato" keeps popping up on your television screen is association with the term "no confidence."

We are, of course, talking about Japan, where all of the political fighting occurs within the dominant Liberal Democratic Party (LDP, no liberal democrats by American standards need apply). "Kato" is a reference to Koichi Kato, who is trying to oust Prime Minister Yoshiri Mori in a vote of no confidence. The reference to a moribund stock market has been valid since 1990, and there's no relief in sight.

A Little Extra Surplus

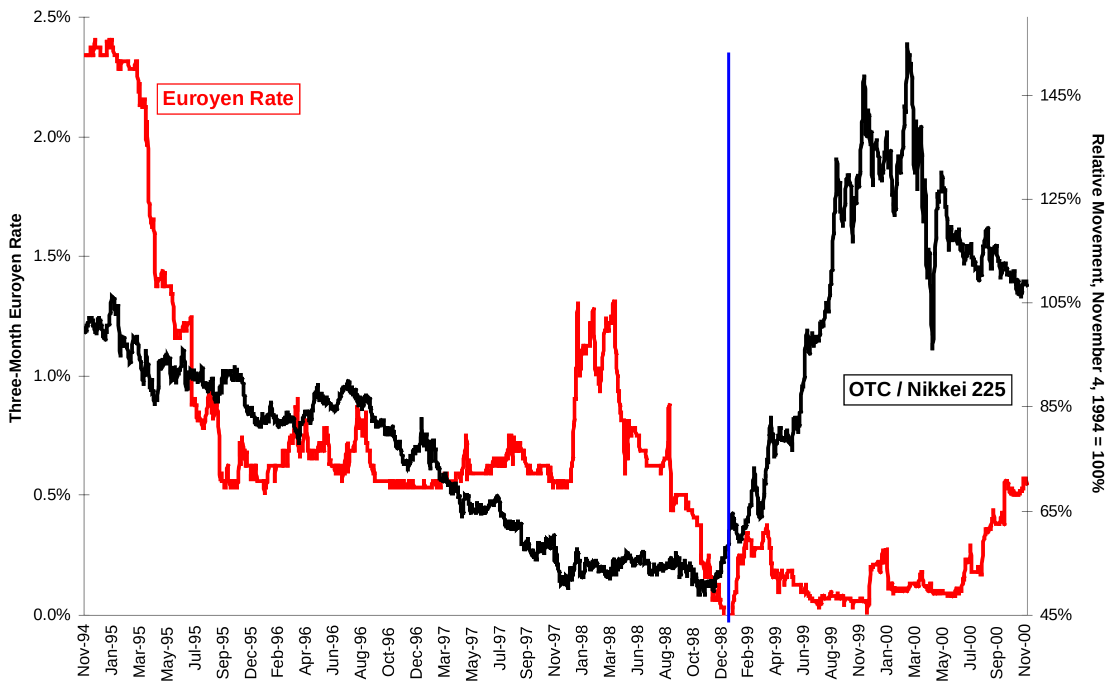
Japan's trade surpluses have been an intractable problem for the global economy for several reasons. First, importers of Japanese goods, the United States in particular, have moved into sizable debts to Japan. Second, Japan is a mature industrial superpower and should not be competing for the same markets as newly industrializing economies seeking export-led growth. Third, the Japanese consumer has been deprived of the fruit of his own labor. Fourth, the yen is way over-valued given the minuscule rates of return on Japanese deposits. Fifth, Japanese policies designed to increase domestic consumption and investment and thereby reduce these surpluses have backfired. The single-party system has indulged in an orgy of pork barrel spending and cheap money that have led to huge government deficits and the financing of financial bubbles elsewhere, especially during the 1995-1999 period. Moreover, efforts to erode these surpluses via exchange rate manipulation have failed, as seen below.



The misdirection of investment to construction boondoggles may have lubricated frictions within the LDP and satisfied campaign contributors, but this starved Japan's entrepreneurial class, already laboring against Japan's group-oriented culture and bank control of venture financing, of badly needed capital. As a result, the Nikkei OTC index underperformed the benchmark Nikkei 225 index severely until the end of 1998. At this point, the Ministry of Finance finally allowed struggling banks and securities firms to start failing.

The Bank of Japan chipped in at the same time with a final lowering of interest rates to virtually zero. Incredibly, with the Japanese economy still suffering from deflation near 10%, these interest rates may have been too restrictive. Still, the combination of this flood of yen and a hint of regulatory reform led to a huge rally of the OTC market relative to the Nikkei.

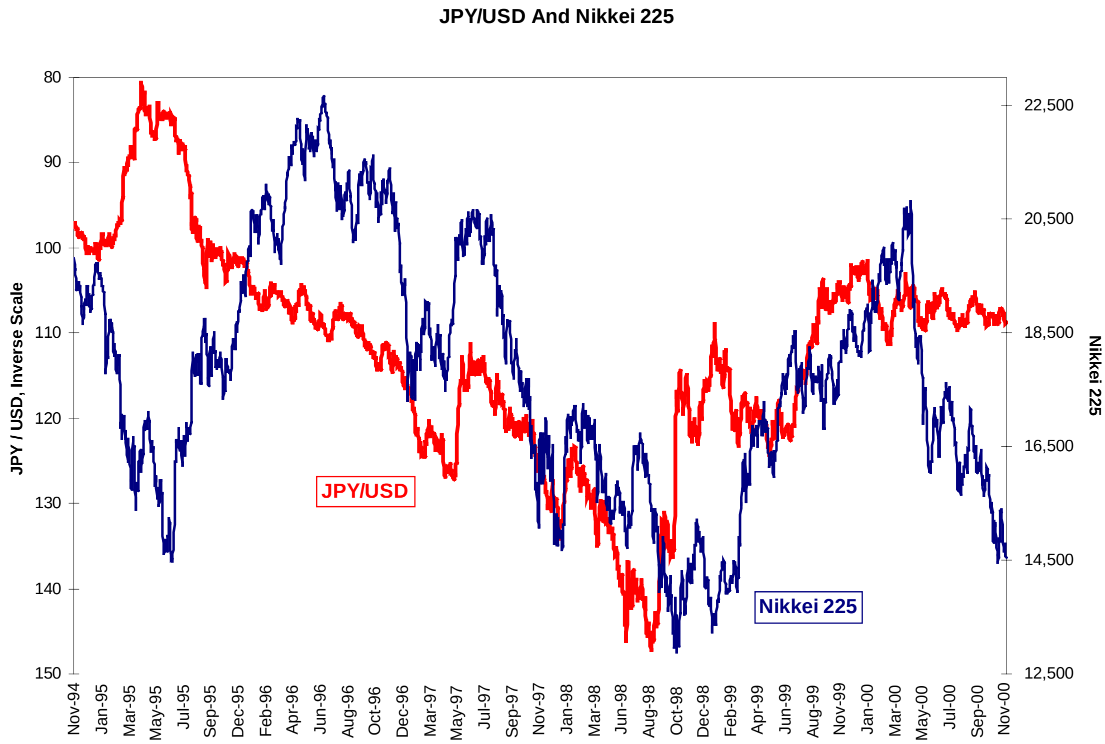
Relative Movement of Nikkei OTC Index To Nikkei 225 Versus Euroyen Rates



What Happens Now?

It was said of the Bourbon kings of France that they learned nothing and forgot nothing, but this trait is hardly unique to French royalty. The LDP is reminiscent of the large corporate bureaucracies that used to dot the American landscape: It's second verse, same as the first, a little bit louder and a little bit worse, because in a sheltered environment the internal politics become far more important than the external realities. Restated, if Japan, Inc., were an American corporation, it would go the way of so many other corporate dinosaurs.

The Nikkei and the yen have an unpredictable relationship. As recently as 1995, the Nikkei rallied on the prospect of easier money and a weaker yen. This weaker yen would support Japan's export industries in their competition against Korea and Taiwan, at the cost of exacerbating the permanent trade surplus. By late 1996, the failure of this strategy became apparent, and the Nikkei fell along with the yen into the Russian crisis of 1998. The yen revalued sharply in October 1998 as U.S. interest rates fell, and the Nikkei rallied shortly thereafter when it became apparent that Asia wouldn't collapse.



Since the end of the global technology bubble in April 2000, which occurred simultaneously with the end of Japan's zero-rate policy, the Nikkei has plunged while the yen has formed a bullish pennant on the chart. One interpretation of this combination would be the fear of a sharply higher yen as the Japanese trade surplus maintains demand for the currency. The higher yen will place Japan's exporters at a competitive disadvantage and perpetuate the decade-long recession.

The only way out, as seen from these quarters, is to encourage Japanese entrepreneurs via low interest rates, venture funds, and a change in cultural attitudes at the highest levels. Export dependence is doomed to failure: There is no way for Japan to compete on a cost basis with China.

Can the LDP restructure itself to lead this and other changes? Not unless "Kato" means something different in Japanese than it does in English.