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ECONOMIC VIEWPOINT
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Keep Your Eye On Japan; The world has a huge stake in Koizumi's financial reforms

Political and business attention in the U.S. is focused on China's rapid and spectacular emergence as a global economic player. But the unfolding political drama surrounding Japanese Prime Minister Junichiro Koizumi's attempt to reform his country's antiquated financial system also contains some important lessons for the global economy.

It's easy to see why interest in Japan has been eclipsed by that in China. With its economy growing by about 9% over the past year, China is galloping relative to Japan's slower growth of less than 2.5%. And many economists believe China's annual growth in gross domestic product could be 8% for many years, while Japan's potential GDP growth rate is closer to 1.5%. But this comparison, while likely, doesn't offer a fair assessment of Japan's potential cyclical contribution to global GDP expansion over the next few years. Japan remains the world's second-largest economy, with a GDP almost three times that of China. So a rebound in Japan -- and there's growing evidence of one -- would provide a much-needed boost to global growth now.

The financial reforms championed by Koizumi can raise the growth rates for both Japanese productivity and the economy. That faster pace would, in turn, reduce Japan's looming fiscal stresses. And successful financial reforms in Japan can offer a road map for economic restructuring in China, whose creaky financial system requires modernization if the mainland is to keep growing at a rapid rate.

The economy Koizumi inherited in 2001 had been languishing since the crash of Japanese equity and property markets in 1990. Banks struggled with nonperforming loans, racking up taxpayer bailout costs and channeling loans to large but insolvent businesses while strangling the abilities of new entrepreneurial businesses to obtain credit. And the '90s saw a big increase in public-works spending, benefiting the politically connected construction industry more than Japan's long-term growth.

KOIZUMI HAS MADE SUBSTANTIAL progress in banking reform. Japan's bank regulator is no longer a captive of its regulated clients. Nonperforming loans have been reduced. And wasteful public-works spending has been trimmed. Those developments have helped taxpayers and borrowers alike.

But Koizumi faces a far bigger challenge in his bid to break up and introduce competition for the postal system, Japan Post, whose $3.3 trillion worth of deposits and life insurance policies lie at the heart of Japan's financial restructuring and growth ills. By offering subsidized rates to depositors and policyholders, Japan Post puts private commercial banks and insurers -- both Japanese and foreign -- at a competitive disadvantage. That the funds are used in part to finance subsidized loans and public-works projects further distorts the nation's allocation of capital. A breakup of Japan Post would both stimulate competition in the financial sector and limit the flow of public funds to wasteful public projects. In short, picking this fight was a smart economic policy move.

And what a fight it is. Koizumi's plan was to split Japan Post into separate pieces for mail, banking, insurance, and property management. Government ownership (and preferential tax treatment and public guarantees) was to cease by 2007. His moves met with enormous political opposition within Japan's ruling Liberal Democratic Party. When the Prime Minister lost a critical vote on the breakup in the Diet's upper house on Aug. 8, he pulled the brake, calling for general elections for the lower house on Sept. 11.

The U.S. has an economic stake in Koizumi's success. The postwar revitalization of the Japanese economy is one of the outstanding episodes in modern economic history. Better performance would continue this story for the next generation, while easing pressure on the U.S. economy to fuel global growth. A politically and economically muscular Japan is a better ally on the world stage. And successful restructuring in Japan serves as an example of the benefits of reform for emerging capitalists like China as well.

Investors would also benefit. China, of course, is today's star. But it and many other nations lack some of the special characteristics that make Japan so attractive to investors: a positive business climate, rule of law, advanced infrastructure, a highly skilled workforce, and affluent consumers. Financial reform offers the best hope to further strengthen these positive attributes -- and Japan's long-term growth.