

Backs to the Wall

The world was slow to recognize the trouble in Japan and Germany. Now, on the eve of momentous elections, it may be missing the signs of a comeback.

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Newsweek International

Updated: 1:41 a.m. ET Sept. 4, 2005

Sept. 12, 2005 issue - World economic headlines these days are all about the United States, China and India. But only a decade ago Japan and Germany were still in the Big Three. Industrial giants with powerful currencies, dynamic companies and highly productive work forces, the two nations were widely seen as models of capitalism with a more human face, real rivals to the Anglo-Saxon version. At the time no one imagined that their emerging troubles would prove so durable, or that India and China would come on so fast. Japan seemed sure to remain the dominant player in booming East Asia, and Germany the undisputed leader of an ever-widening European Union.

What happened next is no secret: economic stagnation set in. The two giants were geared to an older industrial age, with rigid labor laws and antiquated banking systems. Their corporate cultures rejected entrepreneurs, their politicians lacked the courage to force potentially painful modernization on their complacent and satisfied populations. Japan and Germany lost their technological edge to the United States, their manufacturing edge to Asian upstarts. And as slow as the world was to understand the depth of their slide, so we have yet to recognize signs of a comeback. Upcoming elections on Sept. 11 in Japan and Sept. 18 in Germany could be remembered as the pivotal moment when these two giants regained their lost momentum.

The stakes could hardly be larger. Japan and Germany still have far more immediate impact on the world economy than the emerging giants, China and India. Together they account for about 17 percent of global GNP, but Morgan Stanley figures that with reasonable reforms, that number could be upped to 22 percent. By comparison, America contributes 28 percent and China a mere 4 percent. In other words, reforms in Japan and Germany could contribute more to the world's income than China's entire economy does today. A healthy Japan would give many Asian countries an alternative to growing dependence on sales to China; a recovery in Germany could help revive all of Europe. And rising demand in both countries would help trim the American trade deficit, easing the threat of a sharp fall in the dollar, and the U.S. economy.

Politicians in Tokyo and Berlin are calling these elections the most important since the late 1940s, and they are right. The deeper question for both countries is also strikingly similar: whether to overhaul welfare-capitalist models that delivered spectacular recoveries after World War II, growth and stability throughout the 1970s and '80s, but are no longer competitive—not even remotely—in today's globalizing economy.

In Japan the central issue is Prime Minister Junichiro Koizumi's plan to dismantle the largest state-owned component of the financial system: Japan Post, which is the nation's largest insurer and largest savings bank, with \$3 trillion in deposits from 80

million Japanese. Japan Post and the state are joined at the hip, with the government guaranteeing postal deposits and the Post buying government bonds at low rates. Breaking up this relationship would allow trillions in captive capital to seek higher returns—which, in essence, is what most reforms in Japan will be about.

Even more than in Japan, the German election is specifically about wholesale change. A broader number of issues are front and center, including tax, pension and health reform. The advisers to Angela Merkel, chairman of the Christian Democratic Union and Chancellor Gerhard Schröder's opponent, have talked about changes in taxes that would lower the deficit as well as encourage German conglomerates to sell off unrelated subsidiaries and thereby unlock value. They have talked about further eclipsing the power of big unions. Merkel herself has been building bridges to Germany's top business leaders.

If the reformers win, they will take power with wind in their sails. In Japan, the most important change so far has been the shoring up of a bankrupt banking system. Billions of dollars of bad loans have been removed from balance sheets. A wave of mergers has consolidated strong and weak institutions. The government has improved its supervision of banking.

Like Japan, Germany has identified the crux of its problem and attacked. Although political stalemate has slowed change in Germany the past two years, Schröder has taken some important steps to pierce the social market system in which the state coddles both labor and companies. The government has made it more difficult for the long-term unemployed to collect high pensions and has subjected social benefits to means testing. It has lengthened working hours and decentralized collective bargaining with unions.

The most transforming force in both Japan and Germany may be the impact of foreign investors. As late as the mid-1990s the main providers of capital in both countries were the domestic banks that maintained cozy ties to industry and all but ignored shareholders or modern corporate-governance standards. In recent years, both countries have opened to fierce competition from new sources of capital, including foreign banks like Citigroup, investment banks like Goldman Sachs, private-equity groups like Blackstone, and most recently a slew of hedge funds.

In a landmark transaction that brought all the facets of Anglo-American shareholder capitalism to Japan for the first time, America's Ripplewood Holdings bought Long Term Credit Bank out of government receivership in 2000, restructured it, then sold just part of the company to the public for \$2.3 billion four years later. The deal showed that private capital married to smart management could revive companies given up for dead, and there are many of these in Japan.

An equally sensational event in Germany saw foreign hedge funds led by the Children's Investment Fund of London force the Deutsche Bourse to drop its effort to buy the London Stock Exchange, calling it a bad deal for shareholders. The hedge funds prevailed and forced the resignation of the bourse's CEO and its chairman, giving all of corporate Germany a glimpse of the future.

Japan changed its own laws to let in foreign investors; Germany, after much debate, decided not to block the impact of new European Union rules opening the door. The foreign investors will demand more transparency, accountability and focus on

shareholder returns. They want to buy companies spun off from conglomerates. They want to purchase bad loans at a discount and rejuvenate the assets behind them. They are betting on Japan and Germany as good prospects. And there is no turning back.

Japanese companies, such as Toyota and Canon, are on top of their game across global markets. Nissan's revival under Brazilian-born CEO Carlos Ghosn showed that Japan is more open to foreign management than at any time in decades. This trend was confirmed by Sony's recent decision to hire American Howard Stringer, as its CEO. The gigantic *keiretsu*—families of companies united by cross-holding of shares and a central bank—are unwinding. Individual companies have pared costs, refined their strategies and positioned themselves to take advantage of the growing markets and low-cost skilled labor in Asia.

German industry has sharpened its competitiveness, too. German companies such as Siemens have brought down wage and benefit costs by threatening to move union jobs out of the country. Germany regained its place as the world's leading exporter this year. The stock market has risen strongly in recent months. The lowering of capital-gains taxes in 2001 encouraged big German companies to spin off peripheral businesses, leaving them leaner. Deutsche Bank and insurer Allianz have sold off shares in industrial companies, freeing up their capital to seek higher returns.

To be sure, the upcoming elections could go badly, too, and the reforms that have been started could be stopped in their tracks. Koizumi and Merkel could lose or win by so few votes that they find themselves paralyzed by having to govern with dysfunctional coalitions.

Even if the reformers do win by healthy margins, no one should underestimate the challenges ahead. Both face rapidly aging populations eager to protect the health and pension benefits that have helped drive up public debt to 150 percent of GDP in Japan and nearly 70 percent in Germany. These are among the highest debt levels in the industrial world. Both nations must shift from a growth model driven by exports to one led by domestic consumption—a massive psychological and structural transition.

But the choice is clear: change dramatically, or face mounting societal problems. This is a defining moment for Tokyo and Berlin. Voters in both countries should seize it.

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