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Recommended Citation

Gene Park, and Steven Vogel. "Japan in 2006: A Political Transition." *Asian Survey*, vol. 47, no. 1, Feb. 2007, pp. 22–31.

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JAPAN IN 2006

A Political Transition

Gene Park and Steven Vogel

Abstract

Prime Minister Koizumi Junichiro stepped down in September 2006 after a five-year term in which he reshaped Japanese politics by undermining his own party's political machine, stretched the constraints on Japan's military role, and promoted a program of "structural" economic reform. In his final year in office, he confronted a backlash against his economic reform program and presided over a chill in relations with China and South Korea. Abe Shinzo replaced Koizumi, pledging to repair relations with Japan's neighbors and to promote a pro-growth economic strategy.

Keywords: Japan, politics, foreign policy, economy

Koizumi Junichiro, the longest-ruling prime minister since Sato Eisaku (1964–72), spent his last year in office basking in the glory of electoral victory, economic recovery, and strong U.S.-Japan ties. Yet, he also encountered signs of a backlash against his economic reform program, including public concern about growing economic inequalities, and he presided over a deep chill in Japan's relations with China. When Koizumi stepped down in September 2006, he left his successor, Abe Shinzo, with a very tough act to follow. Koizumi not only enjoyed personal charisma and media savvy that Abe could not replicate but Koizumi also could claim credit for a strong and sustained economic recovery and an unprecedented Liberal Democratic Party (LDP) victory in the September 2005 lower house elections.

Meanwhile, Abe would have to confront some unpleasant fallout from the Koizumi era, including an enormous government debt, the highest among Organiza-

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Asian Survey, Vol. 47, Issue 1, pp. 22–31, ISSN 0004-4687, electronic ISSN 1533-838X. © 2007 by The Regents of the University of California. All rights reserved. Please direct all requests for permission to photocopy or reproduce article content through the University of California Press's Rights and Permissions website, at <http://www.ucpressjournals.com/reprintInfo.asp>. DOI: AS.2007.47.1.22.

tion for Economic Cooperation and Development (OECD) countries at 170% of gross domestic product (GDP), plus the implementation of some of Koizumi's "structural" reforms, including the privatization of the postal system. Abe would also have to try to repair relations with China and South Korea. Koizumi had exacerbated tensions with Japan's neighbors by repeatedly visiting the Yasukuni Shrine, which houses 14 Class A war criminals plus a museum with an alarmingly revisionist interpretation of Japan's wartime history, and he did not miss the opportunity for one final visit on August 15, 2006.

The Koizumi Legacy

Koizumi had come to power in 2001 under the banner of economic reform—and yet he left a greater personal legacy in domestic politics and foreign policy. Some of Koizumi's structural reforms, such as special public corporation reform and decentralization, were already under way before he assumed office. His administration continued, rather than initiated, a broad array of more-technical reforms that have given Japanese businesses new options for restructuring. These ranged from labor market reform to accounting and corporate governance reform. Moreover, Koizumi's economic reform priorities were misplaced. He expended enormous political capital on reforms that were unlikely to produce short-term benefits, such as postal and special public corporation reform, while stalling on the issues most salient to recovery: combating deflation and resolving the banking crisis. To Koizumi's credit, his administration finally addressed the latter issues under the combined leadership of economic policy czar Takenaka Heizo and Bank of Japan Governor Fukui Toshihiko. Koizumi was slow to pursue this agenda, however, and he hesitated to back Takenaka in early skirmishes with the LDP old guard.

On the domestic political front, meanwhile, Koizumi brilliantly executed a strategy of saving the LDP by attacking it. That is, he understood that many Japanese voters, especially those in urban and suburban areas, were fed up with the LDP's old-style political machine, which relied heavily on pork-barrel spending and resource transfers from urban to rural areas. Koizumi undercut this system directly by reducing public works spending and indirectly by reforming the postal finance system and the special public corporations that channeled much of the funding for this spending. Koizumi culminated this strategy with the 2005 election, when he banished those LDP members in the lower house who had voted against his postal privatization bill from the party and recruited "assassin" candidates to run against them. The party won an astounding 296 seats, up from 212, and emerged with a more even distribution of Diet members from urban and rural districts and a large new cohort of "Koizumi kids" who owed their election to Koizumi.

In saving the LDP, however, the prime minister may have undermined the foundation of the party's long-term rule. Koizumi accelerated a trend away

from a party electoral strategy centered on mobilizing clientelistic networks toward greater emphasis on leaders, image, and policies. In its heyday, the LDP had enjoyed strong rural support via a broad social coalition that spanned from farmers to small business owners, as well as through stable clientelistic networks that enabled the party to win elections even with weak leaders, image problems, or flawed policies. The LDP finished 2006 with unprecedented strength in the lower house, yet it was vulnerable in the sense that Koizumi had undermined some traditional sources of party strength and withdrawn its more recent trump card—himself.

Koizumi had come to office with very little foreign policy experience, yet he was surprisingly bold in this realm. Japan under Koizumi responded decisively to support U.S.-led military action in Afghanistan and Iraq. In doing so, the government passed legislation that substantially stretched the limits of Article 9 of the Constitution, thereby redefining the role of Japan's military forces. Koizumi also pushed forward the process of considering constitutional revision.

Koizumi's Final Year: The Backlash

Having secured the LDP's electoral victory and passed the postal privatization bill, Koizumi had few major ambitions for his final year. He pledged to step down at the end of his term as party president in September, leaving Abe and a few rivals to jockey for the top spot. As the glow of electoral victory faded, however, critics of Koizumi's reform program became more vocal. In the fall of 2005, the *Asahi Shimbun* ran a series of articles on economic inequality, and other newspapers and television soon embraced the issue. Analysts noted marked increases in disparities across income groups and geographical regions and some blamed the Koizumi reform agenda for these increases. Meanwhile, the number of households below the minimum income threshold had jumped from 780,000 in 2001 to 1,040,000 in 2005.¹ Polls revealed that a declining percentage of respondents identified themselves as middle class and an increasing number as lower middle class or poor.² Democratic Party of Japan (DPJ) leader Maehara Seiji raised the issue in the Diet in January 2006, noting that the Gini coefficient, a measure of income inequality, had risen during Koizumi's term of office. A *Yomiuri Shimbun* poll found that 81% of Japanese believed that income and other disparities were increasing; of these, 56% believed that Koizumi's structural reforms were to blame.³ In fact, rising income inequalities were driven more by the prolonged economic stagnation and demographic shifts than specific government policies. The inequalities were greatest among

1. *Oriental Economist* (May 2006), p. 7.

2. *Nikkei Weekly*, February 20, 2006.

3. *Asia Policy Weekly*, March 12–18, 2006.

the elderly because the population is aging, and Japan's pension system is relatively weak. The young also suffered from the decline in employment opportunities for entry-level workers during more than a decade of stagnation.

Meanwhile, two entrepreneurs who had symbolized a new ruthless brand of capitalism, Horie Takafumi and Murakami Yoshiaki, fell from grace in rather spectacular fashion during the year. Some commentators even charged that members of the establishment had fabricated scandals to exact revenge upon these upstarts. The episodes certainly marked a shift in the tide against those who challenged Japanese business norms. In January Horie was arrested on suspicion of violating the Securities and Exchange Law by spreading false information. A college dropout, Horie had embodied the image of the maverick entrepreneur. He brazenly bucked tradition as he built up his Internet firm, Livedoor. Then he challenged the media establishment directly with a highly publicized attempt to take over the privately owned Nippon Broadcasting System. The LDP supported Horie as an assassin candidate in the 2005 election, although he officially ran as an independent. Takenaka, Koizumi's economic reform adviser, even campaigned for Horie. Although the entrepreneur lost to former LDP heavyweight Kamei Shizuka, the Koizumi administration's association with Horie backfired in the wake of the scandal.

Then in June, Murakami was arrested for insider trading. Murakami, a former Ministry of Economy, Trade, and Industry (METI) official, even more than Horie, represented a new style of capitalism that could transform Japan. Murakami was an unabashed advocate for shareholder rights who had launched the first hostile takeover by a Japanese company. He challenged a business system characterized by passive shareholders and stable crossholding arrangements. He drew admiration from some, and reservations from many. Even Fukui, the Bank of Japan governor, was implicated in the scandal indirectly as an early investor in the Murakami Fund.

For many, Horie's and Murakami's downfall served as a cautionary tale of the excesses of unbridled capitalism. The two businessmen had offices headquartered in the same Roppongi Hills complex, a posh development that symbolized the new entrepreneurial spirit. Otsuru Motonari, one of the Tokyo prosecutors investigating the pair, articulated the public unease with Japan's market reforms: "We cannot let this become a society where people who sweat from their labor, or who want to work but can't because of restructuring, can be taken advantage of."⁴

Despite Koizumi's success in the 2005 elections, he stumbled in his attempt to revise the Imperial Household Law to allow for a female heir to the throne. Because the two sons of Empero Akihito, Crown Prince Naruhito and Prince Akishino, had not produced a male heir to the throne, Koizumi appointed a

4. *Economist*, London, June 17, 2006, p. 47.

commission to study possibilities for ensuring the imperial line. In late 2005, the commission recommended revising the law to allow for female succession. Koizumi backed the proposal but soon encountered a backlash from members of his own party, including Foreign Minister Aso Taro and Finance Minister Tanigaki Sadakazu. To make matters worse, even some of the first-term Diet members who had ridden to power on Koizumi's coattails in the lower house elections opposed the proposal. Then the reform was put on hold with the unexpected news that Princess Kiko, wife of Prince Akishino, was pregnant. Koizumi bowed to pressure from within the party, even though polls showed a majority of the public supported the possibility of female succession. On September 6, 2006, Princess Kiko gave birth to a male heir, Prince Hisahito, effectively putting the issue to rest.

Koizumi's cabinet approval ratings dropped sharply in the new year, from 59% in December 2005 to 45% in February 2006.⁵ Yet, the opposition DPJ was not well positioned to take advantage of the slump. In the wake of the party's stunning electoral defeat in 2005, the DPJ had regrouped under the leadership of a young and telegenic rising star, Maehara Seiji. Maehara resigned after only six months, however, as the DPJ became embroiled in a fiasco in which a party member falsely accused the LDP secretary-general of having financial ties to Horie's Livedoor. Ozawa Ichiro, a former LDP power broker and the central architect of the party's breakup in 1993, then emerged as the unlikely leader of the DPJ in April 2006. Ozawa had advocated political reform, economic liberalization, and a more assertive foreign policy in his book, *Blueprint for a New Japan*, which was first published in Japanese in 1993. This reform agenda fit awkwardly with the DPJ's policy profile, yet Ozawa was willing to moderate his policy stance as the new party leader. More critically, perhaps, he sought to apply his political skills to strengthen the party's voter mobilization efforts in specific election contests. In the short run, Ozawa was bolstered by a DPJ victory in a lower house by-election in Chiba in April 2006. In the longer run, the DPJ has been unable to dispel the perception that it was not yet ready to govern, although it remained hopeful for a strong showing in the 2007 upper house elections.

The Economy

The Japanese economy passed a symbolic milestone in November 2006 when it surpassed the postwar record of 57 straight months of economic growth, beating out the "Izanagi boom" of 1965–70. The economy experienced moderate inflation during the year, continuing a trend that had started at the end of 2005. The Bank of Japan suspended quantitative targets and returned to a more orthodox interest rate policy in March 2006. As the economy gained momentum,

5. *Nihon Keizai Shimbun* polls, cited in Japan Economic Newswire, February 5, 2006.

the central bank raised interest rates in July. Ironically, however, the economic recovery generated new policy cleavages within the ruling party. Takenaka, who had been shifted to minister of Internal Affairs and Communications in October 2005, favored keeping interest rates low and putting the top priority on growth. Low interest rates would reduce debt-servicing costs, and higher growth would bring in more tax revenue. Takenaka and Nakagawa Hidenao, chairman of the LDP's Policy Research Council, argued that this would be the best route to fiscal reconstruction and downplayed the need for large tax increases. Of course, such a policy line would require cooperation with the Bank of Japan, which is inclined to assert its independence. Finance Minister Tanigaki and Minister of State for Economic and Fiscal Policy Yosano Kaoru put a higher priority on budgetary balance and favored the early introduction of tax increases.

This debate played out in the process of drafting the fiscal reform plan announced in July 2006. The government would cut spending by between ¥ 11.4 trillion (\$98.2 billion) and ¥ 14.3 trillion (\$120.4 billion) over five years to cover roughly 70% of the projected revenue shortfall, and aim to restore primary balance to the budget (revenue minus expenditures excluding debt servicing) by 2011.⁶ Having backtracked on his previous pledges to reduce debt issuance, Koizumi finally did so in his final year in office. But he avoided committing himself to tax increases. The prime minister had promised not to raise the consumption tax under his administration; in the early part of his term, the weakness of the economy gave him sound justification for this. With the recovery in full swing, however, the issue of tax increases inevitably reemerged. Because the fiscal reform plan would not cover the entire projected revenue shortfall, the government will probably have to raise the consumption tax from 5% to 6%–7% in order to meet its own targets for budgetary balance.

The Koizumi administration addressed a final piece of his structural reform package with an administrative reform bill passed in May 2006. The bill called for a 5% reduction of government employees by the end of fiscal 2010. It also reorganized nine government financial institutions. Four would be merged into one, two would be privatized, and one would be abolished. Overseas development assistance (ODA) would also be restructured, with the ODA operations of the Japan Bank for International Cooperation being consolidated under an existing public financial entity, the Japan International Cooperation Agency. With this move, Koizumi continued a process started in the early 1990s, reducing the number of posts designated for retiring bureaucrats who “descend from heaven” (*amakudari*) into lucrative positions in quasi-public or private corporations.

6. *Nikkei Weekly*, July 3, 2006, p. 6.

Foreign Relations

During 2006 Koizumi continued to solidify ties with the United States. In May the two governments agreed to realign U.S. military bases throughout Japan and transfer 8,000 U.S. Marines from Okinawa to Guam. The two sides failed to agree on cost-sharing arrangements and other contentious points by the target deadline in March, but they bridged the key differences soon thereafter. Japan would cover most of the cost of relocating the troops. The Japanese government moved ahead with the military base realignment agreement despite strong opposition from the local governments that would be affected. In Iwakuni in Yamaguchi Prefecture, 89% of local residents voted in a plebiscite in March to reject a plan to relocate American aircraft and military personnel to their area.

The Koizumi administration unequivocally asserted the primacy of the U.S.-Japan military alliance, insisting that the vote would not affect the realignment. Washington and Tokyo also moved forward with joint development of a missile defense program, deploying military radar in Aomori Prefecture as part of an early warning system against incoming missiles. They successfully tested a Japanese developed nosecone for missiles armed with a warhead for destroying ballistic missiles. Koizumi finally withdrew 600 ground troops providing humanitarian assistance in the Samawah region of Iraq in July 2006, bringing to a close one of his boldest foreign policy moves. The prime minister completed his tenure in office with a feel-good farewell tour in the United States during which he toured Graceland, the estate of his personal idol, Elvis Presley.

The Koizumi administration played a leading role in responding to North Korean missile tests in July. After North Korea test fired seven missiles, including an unsuccessful launch of a long-range Taepodong 2, Japan announced sanctions and criticized the Pyongyang regime for violating a moratorium on missile tests. North Korea had negotiated the moratorium with the United States in 1999 and reaffirmed it with Japan after Koizumi's historic visit to North Korea in 2002. Japan moved quickly to sponsor a U.N. Security Council resolution with support from the United States, Britain, and France to censure the North Korean regime. The Chinese and Russians blocked the sanctions proposed in the draft, but Japan and its allies were still successful in closing ranks and passing a clear resolution. The hardline rhetoric of Japanese leaders, including calls for retaliatory strikes against North Korea, drew a backlash in South Korea with President Roh Moo Hyun himself criticizing Japan for this provocation.

Koizumi's visits to the Yasukuni Shrine contributed to a growing deterioration in relations with both China and South Korea. Koizumi kept his campaign promise by visiting the shrine as prime minister for one last time on August 15, the anniversary of the end of World War Two. Beijing and Seoul protested, but the reaction lacked some of the rancor of earlier outbursts because leaders

of both countries had already resigned themselves to waiting for Koizumi's replacement before trying to improve ties with Japan.

The Succession Race

For much of 2006, the domestic political scene revolved around the race to succeed Koizumi as party president and prime minister. On the heels of the lower house electoral landslide, Koizumi was positioned well to influence the selection of his successor. The prime minister made it clear that he preferred a candidate who would be willing to continue his economic and administrative reforms. While not explicitly endorsing Abe, a popular younger-generation Diet leader, Koizumi offered his tacit support. Abe had made his name by taking a hard-line stance against North Korea over the issue of kidnapped Japanese nationals. Despite his distinguished political pedigree as the grandson of postwar Prime Minister Kishi Nobusuke and son of former Foreign Minister Abe Shintaro, he did not serve in the cabinet until Koizumi appointed him as chief cabinet secretary in October 2005. Abe quickly jumped out as the front-runner in the race for prime minister.

The public debate among the contenders for the LDP presidency revolved around the issues Koizumi had left unresolved, especially fiscal reform and Sino-Japanese relations. Precisely because Koizumi had vowed not to raise the consumption tax, this question fell to his would-be successors. Given the magnitude of Japan's fiscal deficit, it would be irresponsible not to consider tax increases, yet raising the consumption tax would be highly unpopular. Finance Minister Tanigaki, one of the contenders, argued that raising the consumption tax would be essential for fiscal reconstruction and proposed a hike from 5% to 10%. Tanigaki also criticized Koizumi's fiscal reforms for not doing enough to restore fiscal balance. Foreign Minister Aso and former Chief Cabinet Secretary Fukuda Yasuo took more moderate positions. Abe adhered most closely to Koizumi's course, focusing on increasing revenues through growth and decreasing expenditures by reducing the size of the budget.

As relations with Japan's neighbors deteriorated, a backlash ensued. The Japan Business Federation (Keidanren), which was concerned that the political fallout might undermine Japan's business relations with China, called for the prime minister to cease visiting the Yasukuni Shrine. Tanigaki criticized Koizumi's visits; Fukuda called for the erection of a separate national war memorial to honor the war dead; and Aso backed a proposal to defuse the problem by nationalizing the shrine. Koizumi's visits were supported by Abe as chief cabinet secretary, a position that was natural for the latter given his more conservative view of history and his hard line on China and South Korea. Then in April, Abe himself made another pilgrimage to Yasukuni. However, he refused to say whether he would visit the shrine as prime minister. The Yasukuni issue took another turn in July when it was revealed that Emperor Hirohito, the

Showa Emperor, had refrained from visiting the shrine because of the Class-A war criminals buried there. This provided potential face-saving cover for Abe, who could choose not to visit the shrine by invoking the position of the former emperor.

In the months before the vote on the LDP presidency, Abe maintained an overwhelming lead in public opinion polls and within the LDP. Fukuda, the only credible rival, decided not to run, leaving only Aso and Tanigaki in the race. Abe captured 66% of the ballots, a higher share than Koizumi's in 2001. Abe's election reflected yet another Koizumi legacy, a shift in the way in which prime ministers are selected. Like Koizumi in 2001, Abe prevailed in 2006 because of popularity and strong support from local party chapters rather than a favorable factional balance and behind-the-scenes maneuvering.

The Abe Opportunity

Not surprisingly, Abe sought to start off his term by taking the initiative in the one area where he was most likely to improve on the Koizumi record: relations with China and South Korea. Koizumi had been unwilling to bend on the issue of visiting the Yasukuni Shrine, so he had little prospect for better relations with Japan's neighbors. Abe moved even more quickly than observers had expected, visiting both China and South Korea within two weeks of taking office. As it turned out, Abe's advisers had been working secretly behind the scenes to arrange the visits in advance. They reportedly assured the Chinese that Abe would not visit Yasukuni Shrine for at least one year.

The North Korean regime then shook the international community once again by testing a nuclear weapon on October 9. Japan preempted the United Nations by announcing an expansion of economic sanctions on October 11, banning all imports, denying port entry to vessels registered as North Korean, and prohibiting the entry of North Korean citizens into Japan. The Security Council followed with a resolution condemning the test on October 14, with even the Chinese and Russians agreeing to impose sanctions on Pyongyang. In the wake of the nuclear test, Foreign Minister Aso and LDP Policy Research Council Chair Nakagawa Shoichi even suggested that Japan might consider developing its own nuclear weapons, but Abe insisted that it would not.

Abe's cabinet selections suggested that he would emphasize foreign affairs over economic policy and would favor upgrading Japan's military role and capabilities. He reappointed Aso, who had antagonized the Chinese with his public remarks. He installed Kyuma Fumio, who favored upgrading the Defense Agency to ministerial status, as the agency's new director-general. And he appointed Koike Yuriko, a former environment minister, to a newly created post of national security adviser. Abe appointed Nakagawa Hidenao, the architect of the fiscal reform scheme, as secretary-general of the LDP, suggesting that Abe would probably follow through with the gist of the plan. Abe pledged,

however, to postpone tax hikes until after the upper house election in July 2007. He sought to portray himself as a gentler alternative to Koizumi by addressing public concern over growing inequality. Before taking office Abe had proposed a “rechallenge” program to give public sector jobs to part-time workers and to use public financial institutions to help failed businesses start over. He also placed high priority on educational reform. And in line with his growth-oriented economic strategy, he announced an innovation initiative building on programs devised by METI.

In the final month of 2006, in an act widely viewed as bowing to internal LDP pressure, Abe brought back into his party the 11 former LDP members who had rebelled against Koizumi’s postal privatization bill. While this may have helped his standing with the LDP’s traditional support base, it triggered a wider public backlash and a sharp decline in his cabinet’s already waning level of public support.

Abe has extended institutional reforms from the Koizumi era designed to strengthen the power of the prime minister and the cabinet vis-à-vis the ministries. He formed a new “Team Abe” at the prime minister’s office consisting of four Diet members plus one former bureaucrat as senior advisers and 10 bureaucrats as core staff. He reshuffled the Council on Economic and Fiscal Policy (CEFP), which had played a central role in driving Koizumi’s economic reform program. And Abe announced plans to create a National Security Council loosely based on the American model. Abe thus began his term with an institutional structure that would facilitate top-down leadership from the prime minister. It remains to be seen if he can match his predecessor in exercising personal leadership skills to make the most of the new institutional possibilities.