The Japanese Political Economy under Transition

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Japanese Miracle and its Demise

Up through the early 1990s, one of the most journalistically debated political economic issues was the reasons for and consequences of the seemingly indomitable Japanese economy, often characterized as the "Japanese miracle." From the 1950s to the early 1970s, as is clear from *Chart 1,* Japan experienced unprecedentedly rapid economic growth. Although the growth rate moderated somewhat after the oil crisis of the late 1970s, Japan's rate of growth still outpaced that of all other OECD countries. The Japanese polity also displayed uncommon features, such as prolonged single-party domination by the Liberal Democratic Party (LDP) and strong leadership offered by savvy, powerful bureaucrats.

Journalists and political practitioners alike attributed the secret of the Japanese miracle to its unique institutions and the distinctive behavior of Japanese firms, laborers, and the government. In contrast, the Japanese miracle did not garner the attention it deserved from academics, partly because it was too *unique.* Because the analytical tools utilized in the social sciences are limited in their ability to empirically test unique phenomena with low variance, unraveling the elements underlying the Japanese miracle posed a serious challenge. Political scientists that dared to tackle the enigma of the Japanese miracle typically identified Japan's unique institutions, such as the Ministry of International Trade and Industry (MITI), long-term credit banks, and Japanese history as sources of its economic success. Such explanations often lacked rigid theoretical foundations and were also inherently difficult to test empirically. Neoclassical economists, on the other hand, attempted to legitimize their theoretical account by over-generalizing the uniqueness of Japanese institutions and history, ignoring political aspects, and claimed that the Japanese miracle was nothing special. The ironic outcome of the unique growth pattern of the Japan economy, therefore, was for studies of the Japanese political economy to be pushed to a more peculiar position in the field of comparative political economy.

After the 1990s, the growth pattern of the Japanese economy remained unique, but this time, in completely the *opposite* direction (see *Chart 1*). The average growth rate of Japan in the 1990s was the lowest among OECD countries. Thus, when considered over the past several decades, there was significant variance in Japan's economic output across time.

Moreover, cross-sectional (industrial) variance was as significant as longitudinal variance. The performance of firms significantly varied across industries both when Japan's economic output outpaced and when it lagged behind other OECD countries. The Japanese economy has thus been characterized as a "dual economy," meaning that there co-exist within a single country super-efficient export industries and inefficient domestic industries.

In contrast to the preceding decades, the political and economic turmoil of Japan in the 1990s, and the massive institutional changes that the turmoil precipitated, provide social scientists with an invaluable opportunity to analyze the effects of political economic institutions and institutional changes in economies. Departing from previous analyses that emphasized the unique aspects of the Japanese political economy that engendered the "miracle," we now need a systematic analysis that can explain the Japanese miracle *and* the subsequent economic stagnation, *while simultaneously* accounting for the variance across industries in economic outputs. Implications of such analysis should generate valuable inferences that cut across national boundaries.

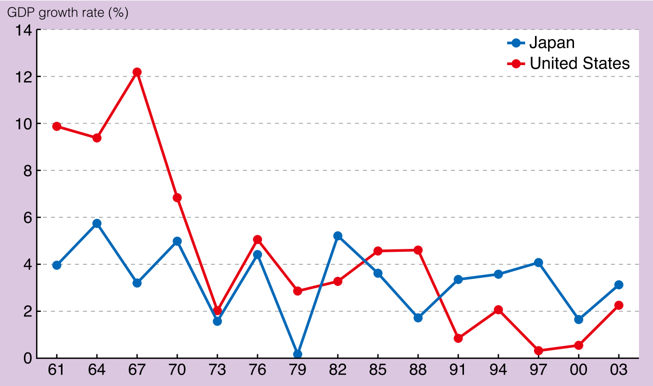
Analyzing Japan's Post-1990 Political Economy

Given the above-mentioned circumstances, I recently conducted research that attempts to explain how once-lauded Japanese political economic institutions and their changes in the 1990s affected economic outcomes. The main purpose of this essay is to introduce the essence of the research.

The primary unit of analysis of the research is industry. Business economists such as Michael Porter have made strong arguments that even in the US, where the market is well-developed, industry does matter significantly. Political economy research that uses industry as a unit of analysis often assumes immobile assets or asset specificity. There is a further rationale for choosing industry as the primary unit of analysis for this research when considering the history and structure of the Japanese political economy. By inheriting the legacy of the wartime economy, industry played a special role in post-WWII Japanese politics. In Japan, as economic historians and political scientists have pointed out, industry worked as a political platform for interest coordination – a role played by social classes in Western countries. The Japanese political economy was vertically partitioned by industry, and so it functioned as the basic unit of political economic coordination. Whereas Seizaburo Sato, a renowned political scientist, called the Japanese version of the iron triangle "shikirareta tagenshugi" (bureaupluralism), Yasusuke Murakami, an economist and a colleague of Sato at Tokyo University, named it "compartmentalized competition." As they correctly pointed out, the LDP and each ministry's departments were divided vertically by industrial sector. As a consequence, political economic institutions and industrial structures varied across industries,

CHART 1

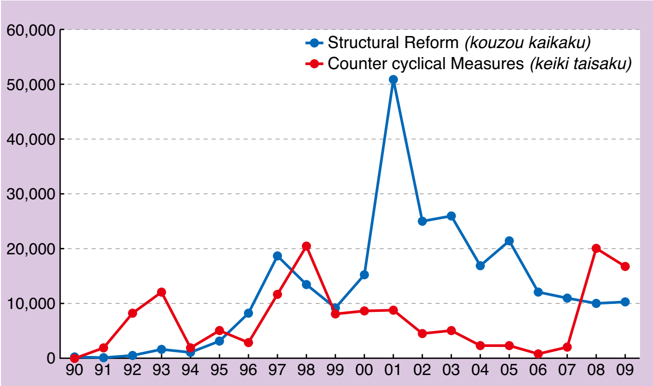
GDP Growth Rate of Japan and United States (3-year average)



Source: Exerted from OECD "World Development Indicator."

CHART 2

The Number of Worlds Matched in Nikkei Telecom Database (Cyclical vs. Structural)



Source: Compiled by author

resulting in the "dual economy," with a high variance of profitability across Japanese industries.

The primary dataset for the economic variables used in the research is the Japan Industrial Productivity Database 2006 (JIP 2006). This is supplemented with political data and other necessary data for statistical tests. The number of industries examined is 70 and the time span of the dataset is 1990-2005.

Post-bubble Economic Policy Debate: Cyclical or Structural?

The major explanatory variables of this research are Japanese political economic institutions and the changes they underwent in the 1990s. In other words, I believe that the structure of the political economy mattered. However, such a claim has been criticized by those who believe that the major cause of the Japan economic downturn since the 1990s was the shrinkage of demand.

The prolonged economic stagnation in Japan in the 1990s, often labeled Japan's "lost decade," attracted wide attention in a variety of countries interested in investigating the causes of and providing prescriptions for the slumping economy. Their approaches can be roughly divided into two types, namely, the cyclical (demand-side) approach and the structural (supply-side) approach. Media and public views strayed between the two sides, as depicted in *Chart 2*.

The proponents of the demand-side approach proposed expansive monetary and/or fiscal policies as potential remedies for Japan's lost decade. Many urged the Bank of Japan (BOJ) to place inflation targets so that the Japanese economy could escape from the trap of liquidation. Their assertions naturally led to attributing Japan's prolonged stagnation to policy failures of the BOJ and the Ministry of Finance (MOF). They blamed the policies of the BOJ and the Japanese government as being "too little, too late." They called for more drastic policies, such as inflation targeting, to realize negative interest rates and/or more expansive fiscal policies despite enormous cumulative fiscal deficits. The ineffectiveness of traditional monetary and fiscal policies during the 1990s, however, resulted in micro-economists (including institutional and business economists), journalists, policy analysts, and others turning to the supply-side approach.

The proponents of the supply-side approach believed that the key problems of the Japanese economy in the 1990s were not just a temporary drop of aggregate demand, as the demand-siders suggested, but were more structural and fundamental. That is precisely why, they claimed, the stagnation lasted for an unusually lengthy period.

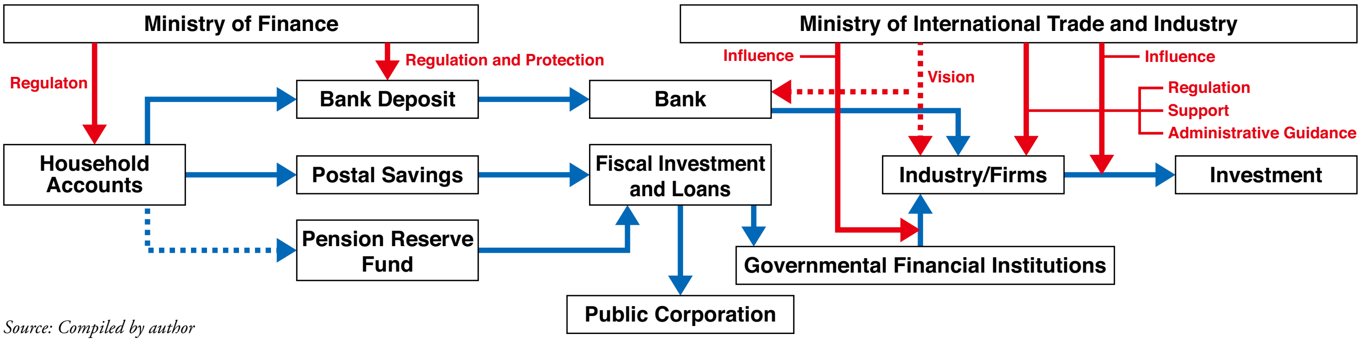
The supply-siders blamed components of the once-successful Japan model as blocking an economic recovery. The key obstacles they identified included such institutions as the main bank system, keiretsu and cross-shareholding, the lifetime employment system, an active bureaucracy, and single political party dominance. According to the supply-side proponents, the Japan model became outdated because it faced drastic environmental changes, such as the globalizing economy, the rise in the productivity of East Asian economies, and the IT revolution. All of these factors resulted, they claim, in a substantial decrease in the competitiveness of Japanese industries and firms.

The supply-siders' prescription for economic recovery was very simple. The Japan model should be drastically and promptly altered through deregulation, corporate restructuring, and political and administrative reforms. Many of these critics insisted that Japan should be more like the US. In order to explain both Japan's unusual success prior to the 1990s and its miserable performance afterwards, they claimed that the Japan model and the industries and firms under this system were well-suited to catching up to developed countries, such as the US, but not to expanding technological frontiers. Governmental intervention in the economy also becomes less effective, they claimed, when technologies approach the frontiers and when the realities of the globalizing economy mean that Japan is not longer able to protect its markets from foreign competition. Many supply-siders concluded that, in order to compete with the US in high-tech industries and to differentiate itself from other East Asian economies, Japan needed to discard most of the Japan model and import various types of institutions from the US. In other words, whereas the demand-siders regarded the economic stagnation of Japan in the 1990s as a short-term phenomenon (i.e., an ordinary cyclical problem) amplified by policy failures, the supply-siders saw it as being rooted in more long-term, structural issues.

Regardless of all the structural changes that took place in the 1990s, many of the supply-siders, in a move interestingly similar to the demand-siders, also insisted that the changes were "too little, too late." The demand-siders, on the other hand, pointed out that the structural changes themselves were a partial cause of the prolonged stagnation.

CHART 3

Japanese Capital Flow System (J-Capital System) **until 1990s**



Source: Compiled by author

Did Structure Matter?

Although I do not deny that the cyclical factor negatively affected the Japanese economy and its industrial output, my empirical examination shows that the structure – a set of political economic institutions – has had enduring and substantially negative effects on industrial output.

The post-WWII Japanese political economy was highlighted by a distinct set of institutions. The so-called "Japanese system," characterized by intimate, informal, and long-term relationships among key political and economic players, was fully functioning during the high-growth era and lasted at least partially until the collapse of the bubble economy. The government-firm relationship in the "Japanese system" is often symbolized by an active and powerful bureaucracy. The once-renowned main bank system and active public financial institutions are typical characteristics of the Japanese financial system. *Keiretsu* is a key feature of the post-WWII Japanese inter-firm relationship.

My research focuses, in particular, on a key subsystem of the Japan model, namely, the Japanese capital flow system (J-capital circulation system), as depicted in *Chart 3*. Under this system, mainly owing to the regulatory power of the Ministry of Finance (MOF), the capital market was underdeveloped, and the flow of capital from households to firms was extremely confined. Since each household had little choice other than depositing its savings in banks, and since firms had little choice other than borrowing from banks to finance their investments, banks played a decisive role in the J-capital circulation system. The bureaucracy, notably the Ministry of International Trade and Industry (MITI), acted as coordinator and information intermediary, positioned in the middle of business-government networks. Inheriting the legacy of the wartime economy, industry functioned as a basic platform for political economic coordination and adjustment. Thus the institutional characteristics of the J-capital circulation system are also long-term industry-bank and industry-government relationships. Industry acted as a platform for political economic adjustments. Capital market and financial coordination mechanisms through the market were underdeveloped until the 1990s.

To statistically test how the J-capital circulation system affected post-bubble economy industrial outputs, I compiled a political economic dataset covering 70 industries during 1990–2005. Data are classified according to three features of the J-capital circulation system: 1) political (government-industry), 2) financial (bank-industry), and 3) industrial structure variables. Political variables, for example, include the number of retired bureaucrats taking executive positions *(amakudari kanryo),* the number of trade associations, the number of regulations, and the number of subsidies, per industry. Financial variables include loans from public financial institutions, loans from main banks, and bank debt equity ratio. Political variables represent the collaborative government-industry relationship whereas financial variables represent the collaborative financial sector-industry relationship. Both are main features of the J-capital circulation system.

The results of statistical tests show that the structure matters, and that the dependence of the industry on the J-capital circulation system had mostly negative and enduring effects on industrial outputs in succeeding years. For example, the higher the values of political and financial variables of an industry in 1990, the less the industrial output of the industry in 2005.

The basic logic that is tested by these statistical results is as follows. The extensive institutional changes in the 1990s that weakened and/or dismantled institutions of the Japanese system impacted the industries that relied more on the Japanese system to solve their coordination problems to a greater degree than the industries that were less embedded. Business-government and business-bank relationships in Japan developed over a long period of time through the creation of various formal and informal institutions, organizations, and contract schemes in order to reduce transaction costs. The J-capital circulation system was at the center of such a Japan model. The wartime political economic structure continued to affect the post-WWII business-government and bank-firm relationships in key industries. Industries that relied heavily on banks and the bureaucracy faced a steep rise in transaction costs during the 1990s, when the Japanese system and its subsystems, including the J-capital circulation system, started to dissolve. Such a rise in transaction costs should lead to a decline of capital investment. In other words, the more embedded the industry was in the original institutional arrangement (i.e., the J-capital circulation system), the more it sustained a negative effect during the period of institutional transition in the 1990s.

Optimal Speed of Change

These results of the statistical test seem to confirm the structurists' (or supply-siders') argument: the Japanese system became outdated and had become an obstacle to economic recovery in the 1990s.

Japan since the 1990s also seems to be following the structurists' policy prescriptions, which are basically to get rid of the Japanese system promptly and import institutional arrangements from the US. Although the view that Japan did not change sufficiently is widely shared by journalists, the vast majority of deliberate research concludes the opposite. After all, not many countries went through electoral reform, a reorganization of government agencies, a banking crisis, and a financial Big Bang in merely a decade. More fundamentally, the values, shared beliefs, and mindsets of the Japanese people have changed. No one in Japan today believes that banks will never default, that bureaucrats are smart and trustworthy, or that land prices will eternally rise. But such views were widely shared by the Japanese in 1990 and were themselves key components of the Japanese system.

Theoretical arguments and empirical evidence show that structure mattered. They also show that Japan executed an extensive institutional change in the 1990s. The J-capital circulation system, the core subsystem of the Japan model and the center of our analyses, was virtually dismantled by the Japanese financial Big Bang and other reforms during the decade.

These results pose another question. If structure negatively affected economic output and if Japan did change its structure rather drastically, why did Japan and its industry not recover more promptly? Why did the structurists' policy prescription – to get rid of the institutional components of the Japanese system as quickly as possible – not work?

Here, the statistical tests show interesting results. Although the industries that were deeply embedded in the Japanese system suffered output loss throughout the 1990s and the 2000s, those industries that changed quickly – usually abandoning institutional components of the Japanese system – also suffered output loss. That is, in contrast to the structurists' claim that structural reforms of Japan and its industries were "too little, too slow," industries that changed "too fast" seemed to suffer output loss.

I constructed a theoretical framework to explain these counterintuitive phenomena. Extensive institutional reforms, even if the reformers aim to change from an inferior system to a superior system, inevitably invite a temporary output fall. A clear example consistent with this framework is the post-communism transitional economies. In 1990 very few would have disagreed with the view that the capitalist system is superior to the communism system in economic performance. The extensive system change from a communist system to a capitalist one, however, invited disastrous economic results.

A country's political economic system is established as a bundle of various complementary institutions. This applies to the Japanese system that supported Japan's high economic growth and to the J-capital circulation system, which was the core sub-system of the Japan model. Political, administrative, and economic institutions of the Japanese system, particularly its subsystem the J-capital circulation system, developed tightly knit, highly complementary institutions. The system allowed industries to solve coordination problems and save transaction costs efficiently when the post-WWII Japanese market was underdeveloped. When Japanese reformers in the 1990s discarded the local maxima – the Japanese system – and aimed for a new local maxima – the Anglo-Saxon model, Japan had to change a set of mutually complementary institutions. The Big Bang approach was intended to minimize the loss of institutional complementarities during the transition. Nevertheless, the complementary relations among institutions were lost during the transition, especially when changes were too fast. For example, Japanese reformers in the 1990s intended to diminish the bank-centered economy and implant an efficient capital market system by importing legal systems mainly from the US. Although such legal systems can be imported in a short time span, complementing institutions such as financial information intermediaries, rating companies, and regulatory agencies need more time to develop due to the time-consuming nature of information accumulation. Knowledge and skills of professionals such as lawyers and investment professionals also require substantial time to develop. Thus, even if market-centered finance might be more efficient in the long run, industries that relied heavily on the main banks had to suffer an increase in the cost of capital in the short run when they sought market-centered finance. More generally, since the speed of institutional change differs across institutions, even when extensive institutional change is carried out simultaneously through the Big Bang approach, a temporary breakdown of institutional complementarities and an increase in transaction costs is unavoidable. This mechanism, I believe, is also one of the reasons why post-communist economies suffered a severe economic downturn during the transition.

Continued Search for New Political Economic System

Extensive institutional changes during the 1990s led to the erosion of the Japanese system. Japan has not yet found a replacement, and the statistical analyses show that industries still struggle with the inevitable output fall during the transition. Coordination failures and the resulting economic downturn in this transitional period are causing a political backlash expressing fond nostalgia for the so-called Japanese system. A critical part of the transition is the search for a new set of institutions that can facilitate coordination among the key players. Japan is still in transition. The search for a new set of institutions that complement each other continues. JS

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