

# The Enigma of Japanese Capitalism

- What Can We Learn from America,

Where the Economy is Subject to the Rule of Law? -

Part 1: How the World's Largest Creditor Nation Landed in a Financial Crisis

By Wasa Takahiro and Sonoyama Hideaki

## Japan's Choice - The Tokyo That Can Say No

1999 was a year of decisive significance for the course of modern Japan's internationalization. By "internationalization," we refer to a process that was set in motion by Japan's relationship with the United States during the waning years of the Tokugawa shogunate, a period of great tumult that laid the foundation for the all-out drive for Westernization known to historians as the Meiji Restoration. Wherein lies the decisive significance of 1999? In the fact that the voters of Tokyo selected Ishihara Shintaro, author of *The Japan That Can Say No*, as their prefectural governor.

Ishihara ran for office on a pledge to radically reform the local government of Tokyo, which had fallen into dire straits. To achieve his objective, he adopted the slogan, "The Tokyo That Can Say No." Say no, that is, to Japan's national government. Tokyo is the capital of Japan, an economic powerhouse among nations. Most of Japan's largest corporations are headquartered there, and they provide Tokyo with a huge tax base. Scattered throughout Japan, however, are more than 3,000 local governments that rely on the central government's revenue-sharing program to survive. For these local governments, Tokyo is what stands between them and financial ruin. With the central government facing a revenue crunch and expecting to rely on Tokyo for support, the people of Tokyo elected Ishihara as governor, a man pledging to "say no" to the central government. Looking at it from a historical perspective, this choice that the people of Tokyo made in 1999, the last year of the post-bubble 1990s, represented more than just the choice of the people of Tokyo. We must see it as

"Japan's choice." This, however, does not seem to be the right choice for an economic power that has made a pledge to contribute to the international community.

## "In America I Saw More than America"

If Japan is to make its rightful contribution as an economic powerhouse to the international community in the 21st century, it must look at America in the same way that the 19th-century French political thinker Alexis de Tocqueville did when he wrote the masterpiece, *Democracy in America*. In that seminal work he declared, "In America I saw more than America." To apply the American experience to Japan, where conditions differ so greatly, it will be necessary to reappraise that experience within the context of a totally reconstructed theoretical framework.

Then, we will find a way to create a theoretical framework that can also be applied in many other countries and regions where conditions differ significantly from those in Japan and the United States. "Experiment" in Japan leads to the development and suggestion of practical solutions for other advanced societies. This represents a Japanese international contribution at a higher level, which will help to avoid the "clash of civilizations" about which Harvard University Professor Samuel P. Huntington has warned us.

Looking back over the history of America, a nation state that certainly fits the Hobbesian definition of a leviathan, three key episodes come to mind. The first is the country's founding, symbolized by the Declaration of Independence, after its victory in the War of Independence. This marked the birth of the leviathan.

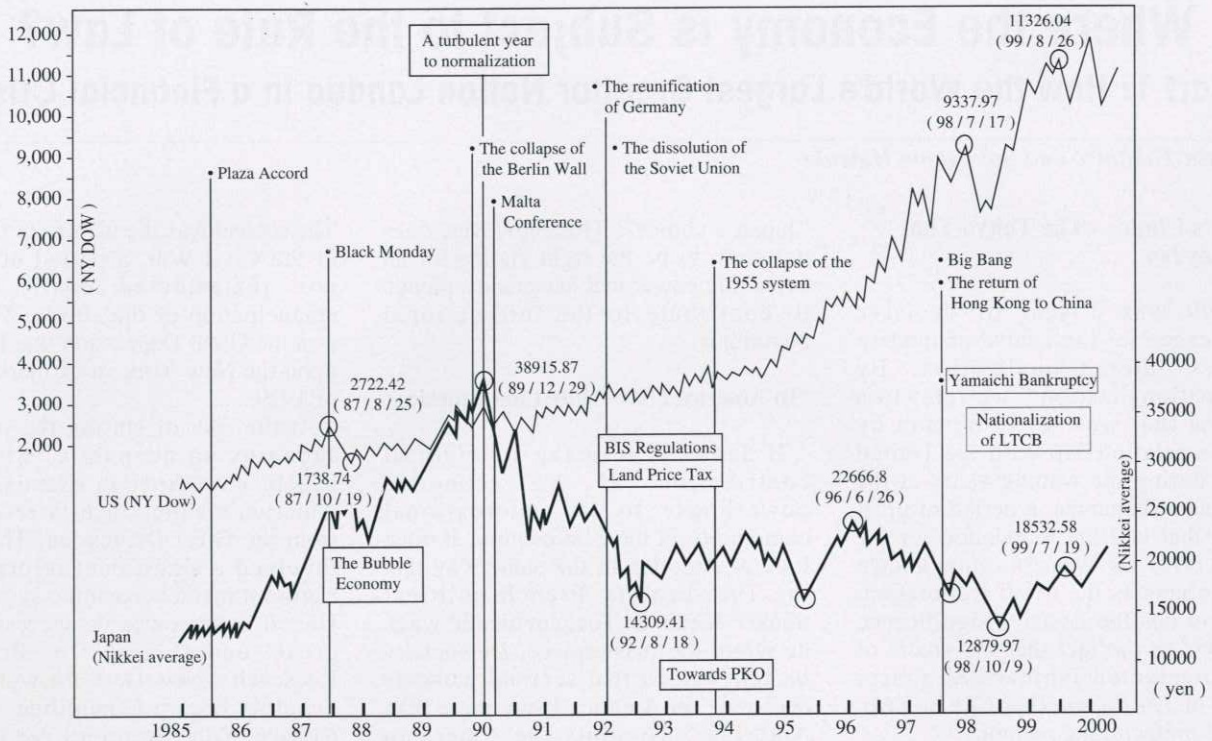
The second was the victory of the north in the Civil War, a period of history now remembered mostly for the emancipation of the slaves. The third was the Great Depression that followed upon the New York stock market crash of 1929.

At the risk of stating the obvious, Japan as an economic nation can benefit most from an examination of America's experience in recovering from the Great Depression. This effort involved a significant reform of its capitalist market economic system. The United States owes its success in this great undertaking to President Roosevelt's New Deal, the work of the Senate's Pecora Committee, and the passage of the Securities Act of 1933, followed by passage of the Securities Exchange Act of 1934 and the establishment of an independent Securities and Exchange Commission (SEC) from the Federal Trade Commission (FTC).

## Essence of an Economic Leviathan - SEC Swings a Big Stick

Sonoyama Hideaki, one of the authors of this article, was sent by the Japanese government in 1976 on a short-term study trip to the U.S. to learn about securities markets there. I attended an enforcement seminar that hammered away with particular insistence on the essential need for political authorities to intervene in financial markets in order to protect the "nation" from the ravages of a capitalist system run amok. This seminar lasted for a week and included more than 50 hours of class time. I was quite surprised at the collection of people participating in the program, either as instructors or students. They included people from virtually every agency engaged in the collection of state secrets on behalf of

Graph 1 : A Turbulent World through the End of the Cold War and Normalization  
 - Japan in the world seen through stock prices -



the government, including the Coast Guard and prisons.

Article 21 of the Securities Exchange Act empowers the SEC's Enforcement Division to: (1) conduct ongoing investigations of anyone involved in securities transactions; (2) subpoena witnesses; (3) issue injunctions against rules infractions; and (4) press legal charges against violators. In order to collect evidence in such cases, the Enforcement Division has the authority to draw upon the resources of the Internal Revenue Service (IRS), the Federal Bureau of Investigation (FBI), the Central Intelligence Agency (CIA), and other government agencies. In addition, the division can also check the records of phone companies, airlines, and the like.

I have continued to watch and study market economies over the last decade or two, and have come to the conclusion that enforcement does more than just prevent the energy of capital from exploding. It also plays a more positive role by enabling the nation's rulers to act as an economic leviathan,

one of the fundamental attributes of any political leviathan.

**Heeding the Market - The Response to Black Monday**

America flexed its muscles as an economic leviathan after stock prices on the New York Stock Exchange crashed in October 1987, an incident that has since come to be known as Black Monday.

Lee Iacocca, then chairman of Chrysler Corporation, sent out the most easily understood message of all in response to the crisis when he contributed an article to the Nihon Keizai Shimbun (published on Nov. 16, 1987.) In his article, Iacocca pointed to the government's runaway deficit spending as the fundamental cause of the stock market crash. His remedy called for the government to cut the deficit by \$100 billion dollars per year. In an effort to rally support for his position, he declared, "The only thing that 'they' (the key leaders in the administration and on Capitol Hill)

have to fear is sound accounting." He also made a very significant statement at the beginning of the article: "I am a firm believer that nothing brings out the unity of the American people faster than war or a sliding stock market." The key point here is his equation of a stock market crash with war. He also stated, "Only a true crisis (or catastrophe) can stir us to action. That is when we are required to put forth our maximum effort."

The economic policies adopted by the United States and Japan after the stock market crash show why the former is a leviathan while the latter is not. Stock prices in Japan fell 21% following Black Monday. It took about a half year for them to return to the same levels again, and by the end of December 1989 the Nikkei Index had risen to 38,915 (46% above its pre-Black Monday level). At that same time, the Dow Jones Industrial Average was only just returning to its pre-Black Monday level. At first glance, it seemed that Japan had the stronger recovery.

### “Victory” of Japanese Capitalism turned out to be a mere Bubble

With the Japanese economy overheating under an ever-expanding bubble, the total market value of the listed shares on the Tokyo Stock Exchange had risen to 20% above that of the New York Stock Exchange by the end of 1987 (at an exchange rate of ¥122:\$1). The yen depreciated to 143:1 by the end of 1989, but even at that exchange rate, total market capitalization stood 36% higher on the Tokyo Stock Exchange than the New York Stock Exchange. Japanese capitalism had triumphed over its American counterpart, and this fact was reflected in the markets. That is what everyone thought, at least.

The numbers, however, had merely been inflated by the bubble. This is what stock prices eventually came to show. After peaking at the end of 1989, the Nikkei Index dropped to 14,309 by August 1992. The bubble economy had collapsed. By 1998 the government had spent over ¥100 trillion (roughly 20% of annual GDP) on emergency economic stimulus measures, yet the Nikkei Index continued dropping, falling below its 1992 level in October 1998. It all calls to mind America's Great Depression of 70 years before.

The stock market crash galvanized the American people to action. They were able to see the warning signs that the market sent out on Black Monday in 1987. Japan, however, reacted to the same warning signs in just the opposite manner. As a result, Japan experienced an even harder landing five years further down the road in 1992. We misread the signals once again in 1992, however, and are now carrying our problems all the way into the 21st century. This is all happening because the world's largest creditor nation keeps putting off financial reform and is digging itself into a deeper and deeper hole.

The Japanese government has placed top priority on economic recovery and has chosen to delay financial reforms until after the country has gotten back

on the road to economic recovery. The public, and especially the business community, supports this policy.

But can this actually be done? Is it truly a rational choice? U.S. history answers these questions quite clearly, but the Japanese government does not have the ability to do what the U.S. government has done. When it comes to managing a capitalist market economy, Japan does not fully possess the philosophy (will) of a leviathan. Even if it did have this will, it does not have the necessary science (know-how) to carry it out.

### Share Price Formation and Japanese Capitalism

What exactly was Japan's bubble economy? It's easy enough to determine its size and impact by looking at the numbers, and it is by no means difficult to show how it affected the market economy.

The most fundamental point concerning the bubble economy is the fact that it introduced a fatal defect into the stock market's share price formation mechanism. Stock market prices exert a decisive influence over the allocation of resources in a capitalist market economy. All sorts of activities that have been either restricted or prohibited by laws and regulations in the U.S. since the 1930s have attracted almost no regulatory notice in the post-war Japanese stock market.

Two typical examples are the tacit allowance of hidden assets due to land appreciation, and lax efforts to eliminate cross-shareholding among corporations. These practices are described in detail in Chapter 9, Misrepresentation and Market Manipulation, in *Fundamentals of Securities Regulation*. This textbook was written by Harvard University professor emeritus Louis Loss, who enjoys a reputation as “the living dictionary of the SEC.” It records the history of the self-help efforts made by America's economic leviathan 70 years ago to escape from the valley of death.

Stock and capital market professionals regard this book as a textbook and a commandment that must never be broken again. It calls to mind the “Ten Commandments” of Moses in the Old Testament of the Bible.

This situation began in the post-war Japanese economy during the Izanagi boom in the second half of the 1960s. The method of procuring funds by listed companies started to change from par value allotments to market price issues. This was followed by the Nixon Shock in August 1971, the depreciation of the dollar and the shift towards a floating exchange rate system. In other words, the conditions for market principles to function in the allocation of funds based on price fluctuations were established in the micro and macro economies.

### Corporate Accounting Subordinated to Tax Accounting

However, no one in the Japanese government or Diet was able to fear “sound accounting.” There was also no one among the economic experts to warn how dangerous this was for an economic leviathan.

In Japan, no one believed accounting, which developed out of double entry bookkeeping, to be the so-called “guardian deity” of the capitalist market economy. Therefore, the principles of corporate accounting based on the Securities and Exchange Law were subordinated to tax accounting. In particular, the entrenched practice of using the acquisition price in the recording and appraisal of land assets intensified the paradox in the system.

Land prices skyrocketed due to the high growth policy of the 1960s. However, property tax, a local tax, remained unchanged at a rate of 1.4% with the establishment of a “tax standard value” for land separately from the posted price with “burden adjustment measures” to address the sharp price increases carried out on the basis of three yearly reviews. As a result, the effective tax rate in Tokyo dropped to one tenth, and at its worst to

Table1 : The Direct Impact of the Collapse of the Real Estate Bubble on Japan's Economy

- The rate of gain and loss of land assets against GNP -

	①Adjusted value (trillion yen)	②Nominal GNP (trillion yen)	①/② %	③Adjusted value of securities (trillion yen)	③/② %
1985	72.9	321.6	22.7	33.8	10.5
86	251.0	336.7	74.5	121.4	36.1
87	412.0	351.8	117.1	74.7	21.2
88	165.4	376.3	44.0	177.5	47.2
89	293.6	402.8	72.9	193.6	48.1
90	225.5	433.0	52.1	- 306.7	- 70.8
91	- 195.5	461.5	- 42.4	- 4.8	- 1.0
92	- 232.6	475.3	- 48.9	- 178.1	- 37.5
93	- 83.1	479.8	- 17.3	4.1	0.9
94	- 44.2	483.2	- 9.1	48.4	10.0
95	- 52.4	487.2	- 10.8	- 25.1	- 5.2
96	- 69.4	505.7	- 13.7	- 25.5	- 5.0
97	- 52.2	514.3	- 10.1	- 93.3	- 18.1

Source: Annual Report on National Accounts (1999)

one twentieth, of what it should have been.

### The "Land Myth" and its Impact on Market Allocation of Funds

This system continued for ten to twenty years, creating a vested interest for landowners and giving rise to the "land myth" in which land was the objective for the most profitable investment. Large listed companies with head offices and factories in major metropolitan areas acquired the "privilege" of evading taxes by using the "hidden assets" resulting from the disparity between the increased land prices and acquisition prices.

This was evaluated as corporate value by stock prices, and market price issues based on the resultant increased stock prices became established and equity financing, including convertible corporate bonds and warrants, developed. The procurement of funds

for industry, which had relied on indirect financing, rapidly shifted to direct financing. These funds went into land acquisition and cross-shareholding, creating a land and stock market bubble.

At the end of the 1980s, when funds were unevenly concentrated among listed companies and large land owners in major metropolitan areas, capital adequacy requirements for banks based on the regulations of the BIS (Bank for International Settlements) became the order of the day. It was the climax of the "alchemy" drama. So-called "non-cost funds" were lent to home financing companies, driving agricultural cooperatives and non-banks out of the market.

### The Trade Surplus Structure as Cause of the Fiscal Deficit

Meanwhile, domestic purchasing power, accounting for over 60% of

GDP, was reduced in both relative and absolute terms. The rights of the majority of workers, who produced added value and paid taxes, were sacrificed. As a result, corporations had no choice but to seek opportunities for profit overseas. They concentrated their efforts on exports, causing the trade surplus to expand and increasing the pressure on the yen to rise.

When the appreciation of the yen reduced the profitability of exports, they tried to cut costs. Wages and payments to sub-contractors bore the brunt of this drive, and domestic demand tapered off even more. This impacted government tax revenues. Keynesian policies were the only way to halt this vicious circle.

A fiscal crisis was inevitable. In Japan, the cause was the unprecedented bubble caused by the land tax system stemming from disregard for, rather than ignorance of, the functions of Adam Smith's "invisible hand."

The main source of the modern state's revenue is taxes. The principle of democratic politics under the rule of law is "no taxation without representation," which America declared as its independence slogan.

The reality of the Japanese land tax system was "send our own representatives to the Diet and avoid taxes." It has already been mentioned that this was the "privilege" of a minority of large landowners and major corporations. At the opposite extreme were the majority of worker households who were "taxed at source without representation" through income tax.

Freedom of transactions for independent economic entities is a basic principle of the market economy. If it is to function as a system, fairness under the law must be established. Where there is disadvantage due to discrimination, rights must be restored for the Japanese tax system to be described as one of constitutional government.

## Restoring the Rights of Taxpayers and the Role of Scholarship

The establishment of taxpayer sovereignty itself is a condition for Japan to become a real modern state as an economic leviathan. The SEC enforcement seminar is also important in terms of this point. In particular, redress for the sacrifices incurred by workers, who have already been taxed at source, due to discrimination in favor of land owners during the bubble period must be prioritized.

Unless this problem is solved, the principle of self-responsibility, which is the basic rule of the market economy, will not take on any reality. Forcing an even greater burden onto the victims in order to deal with the crisis of the beneficiaries of the bubble economy (the assailant) constitutes suicide for a leviathan ruled by the justice of law.

Japan is the world's largest creditor nation. In addition, although the bubble has burst, the value of assets in land and stocks has increased greatly since the beginning of the 1970s. The problem is that it has been "unlawfully" distributed.

Ryu Shintaro, a former chief editorial writer at the Asahi Shimbun, rang the alarm bells about high economic growth accompanied by the paradox of Japanese land taxes and a credit blowout based on land which was rising rapidly in value as collateral, calling the economy "on a binge." An Anglophile journalist, he regarded the assessment of the realities of the unprecedented Japanese social economy using the social science theories of Europe and America as a mistake and advocated that, "It is time that we stopped acting like an academic colony of the West." This was nearly forty years ago.

### Lack of Accountability as Crisis

In order to properly function as an economic leviathan, what Japan can learn from America is the rule of law, which is symbolized in the functioning of the SEC. The weapon to enforce this through democratic procedure, or the principle of majority decision, requires

Table 2 : Real Estate Bubble as a Japanese Problem  
- Comparison of land asset values in the US and Japan -

( December 12, 1990 )

( The Economic Planning Agency )

	Land asset value			US land asset value		Total value of securities at market price TOPIX/NY (NY = 1.00)
	Japan ( trillion yen )	United States ( trillion yen )	US - Japan ratio ( US = 1.00 )	( 100 million dollars )	Doller rate ( yen )	
1955	11.8	87.5	0.135	243.1	360.0	-
60	29.1	129.1	0.225	358.6	360.0	-
65	60.4	163.1	0.37	453.0	360.0	-
70	162.9	208.3	0.78	578.8	360.0	0.07
* 71	197.9	194.3	1.01	617.3	314.7	0.09
75	376.6	312.1	1.20	1,022.9	305.1	0.20
80	700.4	475.5	1.47	2,335.8	203.6	0.28
81	798.8	576.1	1.38	2,615.7	220.2	0.35
82	855.5	628.0	1.36	2,669.2	235.3	0.31
83	889.3	658.3	1.35	2,837.6	232.0	0.33
84	928.5	728.3	1.27	2,895.2	251.5	0.39
85	1,004.0	595.2	1.68	2,967.3	200.6	0.48
86	1,257.2	506.4	2.48	3,165.3	160.0	0.79
87	1,672.6	414.4	4.03	3,396.8	122.0	1.20
88	1,839.3	449.2	4.09	3,568.6	125.9	1.50
89	2,128.7	547.2	3.89	3,816.2	143.4	1.36

( Note ) : Exchange rates until 1970 are fixed rates ( USD 1 = 360 JPY ) ; from 1971, interbank ( Tokyo market ) exchange rate at closing.

US land asset value is based on Balance Sheets for the U.S. Economy 1945 - 1989, Board of Governors of the Federal Reserve System, Washington, D.C. 20051

attention to Lee Iacocca's statement that, "The only thing they have to fear is sound accounting."

It is important for the Japanese people themselves to accurately recognize the true form of the Japanese economy by making use of this social philosophy (value standard) and the systems and policies (science) which achieve it. The problem of a political climate that tolerates a "legal shell" and a "land myth" economic environment is something which cannot be learned from American history, and its solution is a task that we, the Japanese people, must take upon ourselves.

By addressing these problems, the prospect for making America, which differs in history, national wealth conditions and national interest, say "Yes" will become more likely. Japan will be an economic leviathan that can contribute to the great age of competition in the 21st century.

The majority of Japanese people have supported the government in its pledges of international contribution. The problem is one of "lack of accountability and not lack of will." However, the size of the gap between the two creates the atmosphere for "the Japan that can say No." *Beruf* (see Max Weber, *Politik als Beruf* [Profession of Politics] for reference) of journalism is to warn of the dangers of this. **UJI**

*Wasa Takahiro is a former editorial writer and a director of the Capital Market and Corporate News section at the Nihon Keizai Shimbun.*

*Sonoyama Hideaki worked at the Ministry of Finance and the former Wako Securities Co. He is also a former advisor at the Think Tank Fujiwara Office. Both the authors are involved in the Shijo Bunmei Koso Salon (A salon for imaging market civilizations).*