

# Japan's Economic Recovery and the Next Decade

By Jinno Naohiko

## Landings of History

Economic development features what we shall call "landings" – periods of transition that can be likened to the landings of a multi-tiered staircase. The challenge of progress presents itself as a section of stairway that we cannot ascend, forcing us to delay and endure at the landing. Then, having gathered our energies, we continue our climb to the next level.

The vantage of history reveals that the last such landing we overcame was the Great Depression of the late 19th century. It began with the collapse of the Vienna stock market. At the time, this event was viewed as relatively minor by most observers and not accorded much attention. But in retrospect, we can see that the crash in the Viennese market heralded the start of a deep depression, one that lasted from 1873 to 1896 and featured a global plunge in prices.

As this depression wore on, Gerson von Bleichröder, the brains trust of Germany's Iron Chancellor Otto von Bismarck, described it as the most protracted of the past 56 years and lamented that he had no inkling of when a recovery might occur.

The landing that Bleichröder and his generation languished at marked the end of an era. It was also a period of hardship that preceded the onset of a new era. The histories of such landings record dramatic shifts in the way humans use nature to produce goods. The landings thus present an opportunity as well as a challenge: if people fail to make major changes in the way they organize economic production, they cannot move up to the next stage of development.

On the landing of the late 19th century depression, a series of technological innovations propelled a second industrial revolution and dramatically

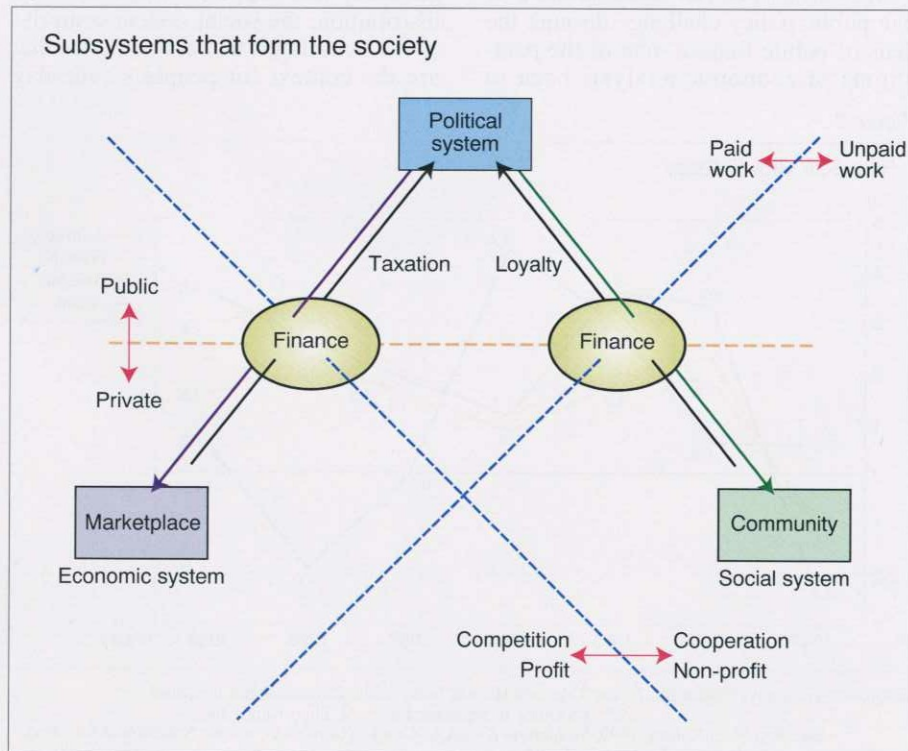
changed the nature of the economy and the commodities produced by it. The industrial structure shifted from one underpinned by light industry to one dominated by heavy industry.

Even earlier, the emergent new era of heavy industry was evident in the revolution in steel manufacturing that occurred through the invention of the Bessemer process. But once the steel industry had satisfied demand for one-off projects such as building railroads, no new demand emerged. The industry thereafter suffered from overcapacity and stagnation. The 1914 outbreak of the First World War was the critical factor that galvanized our ascent from the landing of the late 19th century. Through the economic spur of the war, strategic sectors opened up and brought

in their wake such heavy industries as automobiles and domestic appliances. The era of heavy industry had arrived, melding mass production with mass consumption.

History has now reached another landing near the end of the 20th century, as the era of heavy industry has come to an end. The new era into which we are about to embark is clearly a full-fledged "knowledge society," wherein the key means of production is the highly trained human mind. But to ascend from this landing of history and become a knowledge society requires systemic change, driven by a raft of technological innovations.

Figure 1



## The Social Safety Net and Social Infrastructure Network

Landings therefore pose a trying technological and fiscal context that calls for purposive public policy. Joseph A. Schumpeter highlighted the important role played by innovation in historical transitions. He also pointed out that fiscal crises inevitably appear at major historical turning points, such as the landings that we have discussed. He wrote eloquently of the “turning points, or better epochs, during which existing forms begin to die off and to change into something new, and which always involve a crisis of the old fiscal methods.” It was because of this that he declared public finances to be “one of the best starting points for an investigation of society.”

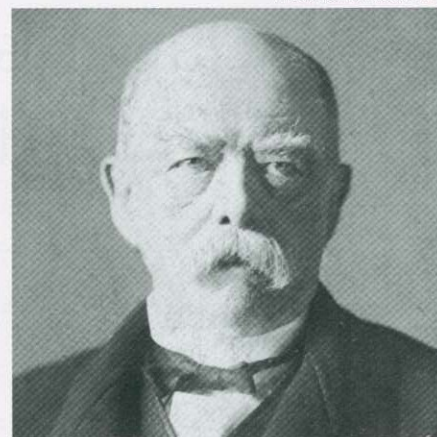
Schumpeter’s approach is of enormous value. He not only shows us that the fiscal system always falls into crisis in an historic landing, but also teaches us that this fiscal crisis is symptomatic of the larger social and economic crises that mark the period of transition.

We can deepen our understanding of the public policy challenge through the lens of public finance, one of the paradigms of economic analysis born to

interpret the challenge of the last landing. New paradigms always emerge in such crises. One product of the depression of the late 19th century is the school of neo-classical economics that arose from the so-called marginal revolution. The other is the theory of public finance that originated in Germany. The neo-classical paradigm puts the market to the fore of the analysis and has become the mainstream approach in contemporary economics.

Public finance, on the other hand, is more comprehensive in scope, and sees the market economy and the state’s finances as the dual axes of the national economy. It is thus more activist in its conception of what is to be done in response to the crisis of a landing.

The purposiveness of this public finance approach is built into its theoretical apparatus. Its vision of public finance highlights the fiscal system as the node that links the three subsystems – the economic, social and political subsystems – that compose the overall society or social order. In this conception, the economic system is the market economy that supports production and distribution; the social system comprises the households and communities that are the context for people’s everyday



Germany’s Iron Chancellor Otto von Bismarck

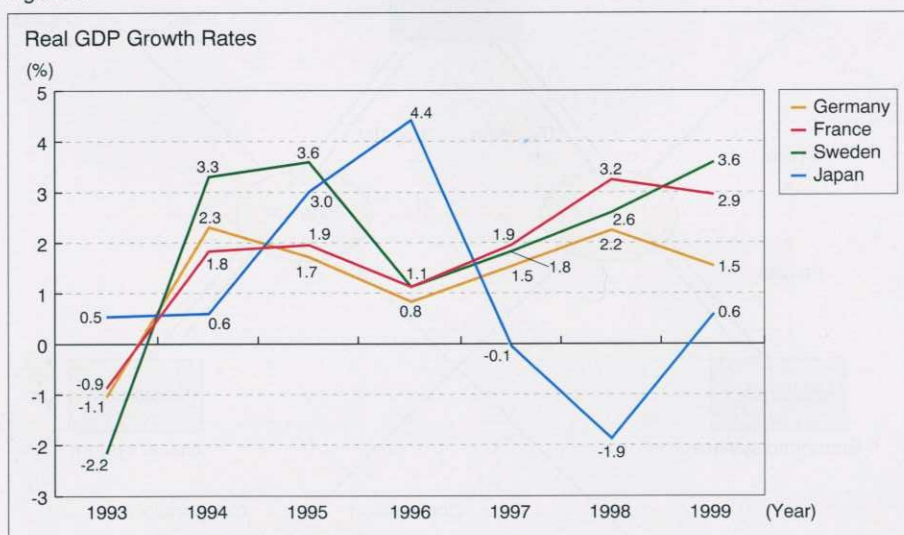
lives; and the political system integrates society through relationships of governance. (Figure 1)

We cannot ascend from an historical landing without a profound renovation of the economic system that forms the industrial structure. Such a shift is a multifaceted policy challenge when seen from the perspective of public finance. This is because a structural change in the economy drives correspondingly large-scale changes in the social and political systems.

Recall that the 19th century depression was deep enough to make Bleichröder despair of the possibility of recovery. Pulling free from the malaise required massive technological innovation within the economy, and fostering this innovation necessarily involved the purposive use of public finances. The main exponent of how to use public finances in this respect was the fiscal theorist Adolph Wagner, who exerted a powerful influence on Bismarck.

Wagner insisted that the relationship between the political system and the economic and social systems had to be transformed and that the political system had to adopt two new roles. First, the political system had to provide the prerequisites for allowing the economic system to accept technological innovation. That is, the proper social infrastructure had to be prepared for creating a new industrial structure. Second, the political system had to ameliorate the social tensions that the stresses of technological innovation would exert on the social order. Meeting this second challenge entailed the construction of a social safety net to protect those who fell victim to the changes wrought

Figure 2



Sources: Germany, France and Japan; Takeuchi Hiroshi (eds), 2000, *Zusetsu Nihon no Zaisei* (A Guide to Japanese Finance), Toyo Keizai Inc.  
Sweden; Mori Kotaro, 1999, *Sweden no Keizai no Genjyo* (Current Economic Situation in Sweden), Japanese Embassy in Sweden

by technological innovation.

Bismarck in fact constructed such a social safety net in late 19th century Germany. Among other reforms, he introduced the world's first social insurance scheme. He also organized such infrastructure as railways, harbors, and the other prerequisites for supporting heavy industry.

### The Lost Decade

And so we turn to the Japanese case and its contemporary challenges. In Japan, the 1990s are referred to as the "lost decade." This lost decade was not simply a period in which economic growth went into a stall. It was in fact an era in which both public finances and the market economy, the dual axes of the economic system, fell into crisis. Let us briefly review the record. From the latter half of the 1980s until the beginning of the 1990s, Japan was in the midst of a bubble economy. The bubble burst in the early 1990s and was followed by sluggish economic growth. We can see this in Figure 2, which shows that Japan's growth rate in 1993 – in the wake of the bubble's collapse – was a mere 0.5%.

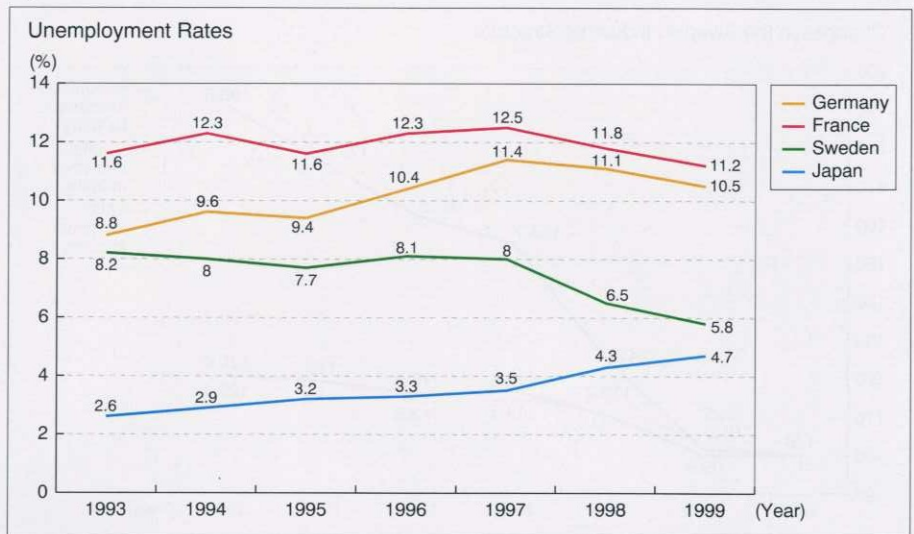
A growth rate of 0.5% is in fact not all that low for a developed country. It could even be regarded as high. But in 1998 Japan's growth plunged to -1.9%; and even though it recovered to 0.6% in 1999, Japan's performance over the



Photo: The Mainichi Newspapers

Joseph A. Schumpeter highlighted the important role played by innovation in historical transitions

Figure 3



Sources: Germany, France and Japan; Takeuchi Hiroshi (eds), 2000, *Zusetsu Nihon no Zaisei* (A Guide to Japanese Finance), Toyo Keizai Inc.  
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entire decade was dismal for a developed economy. Moreover, at the time of writing, Japan has again fallen into negative growth.

Japan's public finances have also greatly deteriorated. In 1993, Japan's public accounts were quite robust relative to other developed countries. But by 1999, its fiscal deficit had become the worst of all the developed countries.

Unemployment is an increasingly serious concern. Figure 3 shows that Japan's 2.6% unemployment rate in 1993 was conspicuously low in comparison to the other developed countries. Of course, the actual figure may be twice this official level, if we include the large number of unemployed housewives who wanted work but could not secure it because of the scarcity of suitable jobs for women in Japan. But even if we double the unemployment figure accordingly, the rate for 1993 remains comparatively low. Japan's unemployment rate worsened considerably during the 1990s, however, and reached 4.7% in 1999. By 2001, Japan's official level of unemployment was 5.4%, a sharp contrast with the Swedish rate of 3.7%.

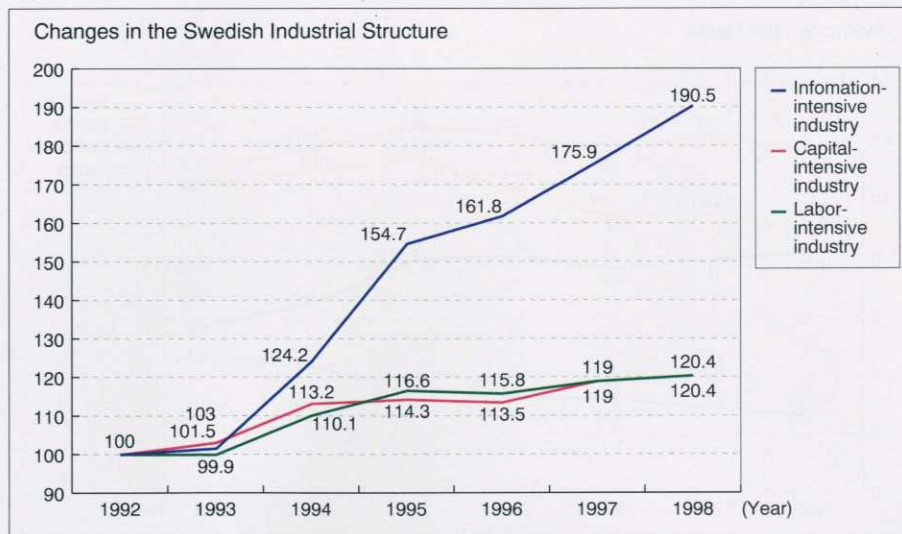
These trends indicate that in the 1990s Japan's market economy and its

fiscal situation both deteriorated. It is thus quite accurate to depict the 1990s as Japan's "lost decade." The loss is even more evident in comparative terms, as in a sharp contrast with Japan, Sweden reconstructed its market economy and public finances in the 1990s. Figure 4 reveals that Sweden's purposive public policy doubled the proportion of knowledge intensive industries in its overall economy. We can thus see the fruits of Sweden's efforts to transform its industrial structure and create a knowledge society.

### Putting the Future in the Hands of the Public

Japan has been at an historic landing since the beginning of the 1990s. To move up from this landing, the country must transform its industrial structure. This effort will entail financing two nets: a social safety net and a network of social infrastructures. In the 1990s, however, Japan cut the financing that should have been available to fund the two nets. Rather than learn from the insights of Schumpeter and Wagner as well as the purposive policy of Sweden, Japan sought to revive economic growth by reducing costs and maintaining the old industrial structure rather

Figure 4



Note: 1992=100 (added-value index)

Source: Swedish Employers Confederation, 1999, Facts about the Swedish Economy 1999, Svenska arbetsgivareforening

than reforming it.

Japan thus devoted its energies to lowering the tax and social insurance burden on the corporate sector. The focus on labor costs saw many of the workers who supply the labor left without jobs. The 1990s in fact saw information technology vastly simplify labor in Japan. It also began to be used to replace workers, who were in turn regarded as mere means. The administrative work of middle managers also continued to be performed by simple labor and mechanized systems. The result was that large numbers of people became unemployed, while those who let them go were regarded as savvy managers.

Private firms and the government became enthusiastic players of the "lay-off game." Through the loss of their jobs, however, people were deprived of a meaningful place in human society. With the unemployed loitering about the streets, the madness of expelling workers from their niche in society became accepted as normal. Others worried that they might be next to join the ranks of the unemployed and thus lose their place in society. This is a vicious circle, however, given that the mass production of this era of heavy industry is founded on high wages and

mass consumption. Cutting wages erodes this consumption. The trend worsens if job insecurity also causes people to reduce their consumption and increase their rates of saving. As consumer demand weakens, mass-produced goods go unsold and the recession deepens. If the downturn worsens, the retrenchment game intensifies and job insecurity becomes more widespread.

Thus we cannot escape the downturn by simply reducing labor costs and the burden of social insurance and taxation. This is particularly true because the contemporary downturn is associated with a transition – in other words, an historic landing. The only way to deal effectively with this crisis is to create a new industrial structure and build a knowledge society. Fiscal resources play an important role here. They must be directed to the establishment of a social safety net and social infrastructures. These will help firms respond to innovation and foster the development of a new industrial structure. Even if we fail to rise to the challenge of creating a new industrial structure, the provision of a social safety net will at least allow us to meet the challenge of innovation with relative equanimity.

But the social infrastructure that I

have in mind is not the roads, railways and harbors that are the prerequisites of heavy industry. Continuing with the policy of implementing a succession of public works projects will certainly not revive the economy. Rather than invest public finances in these infrastructures, we must focus on supporting the information and knowledge industries. The social infrastructure of a knowledge society is the social capital that will enhance people's capabilities.

This focus on social capital reflects an entirely new context of production. In the agrarian economy, the natural resources with which people worked naturally governed the success of an economy. In the era of heavy industry, the machines with which people worked nature governed the success of industries. But in the knowledge intensive industries – whether they be electronics, biotechnology or new materials – the human capabilities applied to nature are what generally determine productivity.

The role of the political system is to establish the conditions for taking on the challenge of creating a new industrial structure. This necessarily entails a tax burden, as we embark on our arduous ascent from this historic landing in common cause, as a public purpose. We shall not be successful in escaping economic stagnation and in rebuilding the public accounts by cutting our finances. Japan's ascent from this historic landing over the next decade depends on robust finances for putting a social safety net and infrastructure network into place. The knowledge society must be one that puts people to the fore, and thus Japan's future turns on whether she can recover based on the dignity of human beings. The essence of this approach, in a word, is the belief in human possibilities rather than the blind faith that we should leave the future to the vagaries of the marketplace. **UJI**

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