

Cyclical Elements and Structural Problems of the Japanese Economy

By Kojima Akira

When the Japanese economy is debated in and outside Japan, the last 10 years of the 20th century are often referred to as "the lost decade." While it is true the Japanese economy basked in euphoria during the second half of the 1980s amid the boom of the asset-inflated bubble, in the early 1990s it was suddenly plunged into the abyss of the longest and worst recession and stagnation since the end of World War II. More specifically, the recession started in May 1991, and the Japanese economy has been growing at a stagnant 1% annual rate on average during the eight years since 1992.

In contrast, the U.S. economy, mired in stagnation throughout the 1980s, bottomed out in 1991, and has sustained fast growth to this day. The same year the asset bubble began to burst in Japan. In February of the new millennium, the U.S. economy entered its 107th consecutive month of expansion, marking the longest boom in the country's history. The boom pushed the jobless rate down to 4.0%, a 30-year low since January 1970. Inflation is somehow under control.

The Japanese economy, which used to steal the spotlight with its full employment of the country's workforce and lifetime employment practices, now has a high jobless rate hovering around 5%, marking the first time since the end of the war that its jobless rate has outpaced that in the U.S. The 1990s was a decade which saw the U.S. resurrect its economy and end up as the sole victor in the world.

What has brought about such differences between the Japanese and U.S. economies and such a historic reversal of fortunes? What do they imply? And, what scenario lies ahead? These factors will be examined from various angles below.

German Nazism, Japan's militarism and the Soviet-led socialist and communist system which challenged the free-market economy and democracy representing American ideology. America is left with no more challengers. America's ideology

and ideals have been firmly established and the process of history's progress has reached the highest level. In this sense, the process of history's progress has already stopped since it has reached the ultimate stage. In other words, historical evolution has run its course.

In stark contrast, Japan has fallen into pessimism and a sense of occlusion, with people talking about "the lost decade" in self-humiliation. The 10

years was also a decade when the authorities were condemned for their mismanagement and misdeeds and lost the trust of the public.

Even the country's bureaucracy was not spared. Long touted as the best in the world, the Japanese bureaucratic system had a reputation of being a grouping of the best and brightest and extraordinarily honest. But during and after the bubble, policy blunders, private scandals and the deterioration of the morality of top bureaucrats surfaced one after another.

What was behind these phenomena? It may be that the extreme nature of the economic bubble degraded people's morals. Not only did it corrupt people at a grassroots level, it also brought about a decisive moral deterioration of



Hosokawa Morihiro's coalition government marked the collapse of the "1955 system"

Photo : Kyodo News

The year 1991 was a historic and symbolic year for the two countries, not only economically but also in other aspects. The Gulf War broke out in January and the multinational forces led by the U.S. scored a one-sided victory over Iraq. In December, the world witnessed the collapse and disappearance of the Soviet Union, the arch-rival of the U.S. in the Cold War, which dominated the international political scene in the 20th century.

In the afterglow of the American triumph, some Americans are even becoming narcissistic, like Francis Fukuyama, author of *The End of History*. What Fukuyama said in his book can be boiled down to this: America has defeated one after another of its strong adversaries such as

Japanese bureaucrats who, it is generally believed, had served the nation and public in selfless devotion and won people's admiration. It was testimony to the inherent danger of an excessive bubble.

In 1993, the so-called "1955 System," under which the Liberal Democratic Party (LDP) had maintained its grip on power without interruption for 38 years since 1955, collapsed when LDP president Miyazawa Kiichi's administration was ousted following the party's loss of a parliamentary majority in a general election. The demise of the "1955 system" has left the nation's political landscape fluid, with cabinets frequently changing hands and all political parties, except the Communists, forming coalitions one after another to seize power.

Hosokawa Morihiro, who succeeded Miyazawa as prime minister of a coalition government formed by former opposition parties, remained in power for only eight months, and his successor, Hata Tsutomu, held office for a mere two months. The subsequent coalition government formed by the LDP and the Social Democratic Party with SDP leader Murayama Tomiichi as prime minister, the first Socialist prime minister in 50 years, lasted 18 months. The next government, formed by the LDP's Hashimoto Ryutaro, lasted two and a half years. Obuchi Keizo was forced to resign in March 2000 due to illness a year and eight months after he took over from Hashimoto, and was replaced by Mori Yoshiro.

Uninterrupted rule by a single political party without any change of government for as long as 38 years in a democratic country was anomalous to other countries.

The sudden collapse of the 1955 system in 1993 can be attributed to the following factors:

- 1. The end of the Cold War meant the end of an era when relations among countries evolved around ideology.
- 2. During the Cold War, the LDP championed the cause of the free-market economy and democracy, while the main opposition Socialists and

Communists maintained their anti-capitalism and anti-market economy ideologies because of their respective sympathies with socialism and communism.

- 3. The Japanese public opted for capitalism as the country's economy grew fast.

- 4. Through its prolonged rule, the LDP acquired various interests and established cozy relationships with the business sector and bureaucracy, known as the political-industrial-bureaucratic complex. This tripartite relationship gradually fostered corruption and immorality since power corrupts.

- 5. During the Cold War, as the LDP played the role of champion of the free-market economy as opted for by the Japanese people, scandals involving the party tended to be overlooked by the public. But this all changed after the end of the Cold War, and corruption cases dealt the party a fatal blow.

The collapse of the 1955 system has left all political parties, except the Japan Communist Party, virtually without ideological identity. This means that there were no longer divisive issues among them. This situation has enabled, and motivated, all political parties except the Communists to join in a coalition. In fact, the Hosokawa administration was a coalition between a new party formed by conservative politicians who split from the LDP, and the Social Democratic Party. The splinter conservatives assumed more of the character of the LDP than LDP members themselves.

The Hosokawa coalition government was the beginning of an era of coalition governments, as six coalition governments came and went from 1993 to 2000.

For foreign countries, including the U.S., that had criticized the one-party rule by the LDP as undemocratic, such



Photo : Kyodo News

Yamaichi Securities Co. failed to carry out financial reconstruction

a political situation may have been welcomed since it embodied the accomplishment of democracy in Japan. However, the extraordinary short life of each government signified a political void. At the same time, it has prompted all political parties to put off political agendas unpopular with voters.

The NIMBY (not in my backyard) syndrome is a popular phrase used in U.S. political circles. It refers to a trend of politicians saying "yes" in general but "no" to specifics. If the fluid political situation in Japan after the collapse of the 1955 system is described in a similar vein, it would be the "not in my administration" syndrome, that is, force all difficult political issues onto the next administration.

When the 1995 structure collapsed in 1993, Japan was burdened by extremely difficult structural adjustment factors - socially and economically - and there was an urgent

need to reform various systems corresponding to structural factors. Unfortunately, however, the successive coalition governments could not afford to let voters make tough choices. Instead, they tended to offer only sweet pills for voters to swallow with an eye to winning the next election. It was as if aspirin was offered to a cancer patient who actually needed surgery.

What then are the structural adjustment factors the Japanese economy and society face? They can be boiled down to:

- (1) classical cyclical factors.
- (2) disposal of financial institutions' bad loans stemming from the burst of the bubble economy.
- (3) adjustment pressures resulting from the decline in economic growth.
- (4) the completion of the process of catching up with Western industrial countries that continued since the end of World War II (or for 100 years since the Meiji Restoration) and the need to build a new economic model for the "post-catch up" period.
- (5) response to mega-competition amid globalization.
- (6) mass accumulation of public debts.
- (7) response to a shift to the technological paradigm of value-added production. This paradigm supports the development of the economy as a whole.
- (8) response to a drastic change in the population pattern resulting from a decrease in the number of children and the aging of society.

These factors represent the new reality facing Japan.

Classical business adjustment (1) basically revolves around adjusting to cyclical waves, such as short-term inventory adjustment and mid-term equipment stock adjustment. This is a problem common to all countries. Generally speaking, responding to the problem is easy. In a free-market economic system, the economy tends to be self-adjusting, leaving cyclical fluctuations to the market mechanism.

Policy-makers can take anti-cyclical measures. In other words, they can accelerate recovery through a demand management policy focusing on fiscal

stimulation (tax cuts and increased spending) and monetary relaxation when a recession hits, triggering a demand shortfall.

In the 50 years since the end of World War II, the Japanese economy has experienced about 10 cycles, with the downward phase of each cycle lasting about four quarters, or 12 months, followed by a sharp and long recovery and expansion. The same held true for the U.S. economy.

The Japanese recession since the burst of the bubble in 1991, however, has basically followed a different course from previous cyclical recessions: the economy fell into recession more sharply than before and the downward phase is extraordinarily long. In the past, prosperity always lay ahead of the recessionary tunnel. In the current recession, not only the future is uncertain but it is also hard to imagine prosperity ahead. That is, a sense of occlusion prevails.

Behind the dismal mood lie various structural factors, as mentioned from (2) to (8). Post-bubble bad loan problems (2) have drastically impaired the credit creation function of the entire economy, because financial institutions were pressured to increase capital, write off bad loans and consequently failed to provide enough loans. The problems have thus created a shortfall in the money supply and loans, which are crucial for an economy's recovery and further development. This has sent the economy deeper into recession and slowed down recovery.

Deposits and cash in circulation usually dominate debates on matters related to the money supply. This is because when deposits increase, financial institutions' lending of money to companies and individuals increases almost automatically. Currently, however, private financial institutions are not positively lending money but instead are trying to recover loans, though they are under pressure to dispose of bad loans and remedy the loss of their equity capital. And, while deposits increase 3% to 4% annually, the balance of financial institutions' lending has been declining continually.

The worst credit crunch took place in the wake of the stock market panic of November 1997, when stocks of financial institutions were sold off following the successive failures of private financial institutions and securities houses such as Sanyo Securities Co. and Yamaichi Securities Co. The credit contraction was attributed to the interbank markets' inability to correct shortages and gluts of funds among financial institutions. It caused the Japanese economy to shrink in real terms (the level of economic activity in real terms went down) in the five quarters since.

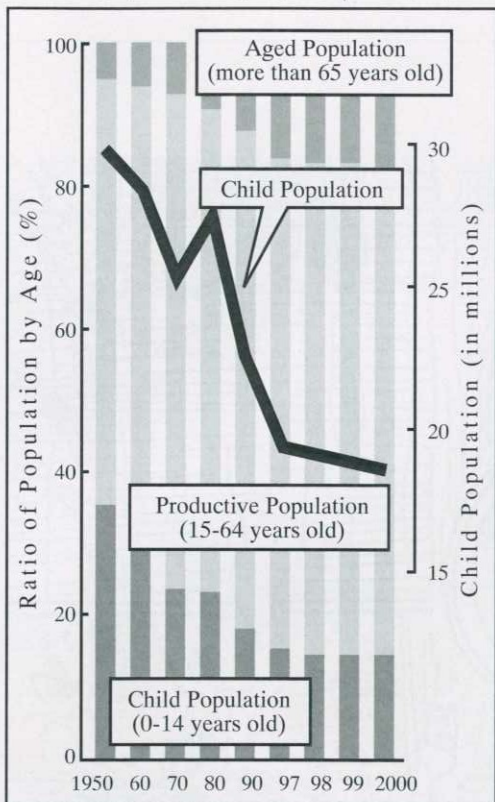
The House of Councilors' election held in July 1998 at the height of the economic crisis cost the LDP its majority in the Upper House, resulting in the collapse of Prime Minister Hashimoto Ryutaro's administration.

Obuchi Keizo, who took over from Hashimoto, made economic rebirth his top policy priority, calling his cabinet "the Economic Revival Cabinet." Obuchi infused as much as 60 trillion yen of special public funds into the economy to protect depositors and shore up the capital bases of financial institutions. At the same time, Obuchi took additional stimulus measures on the fiscal side. These extraordinary emergency initiatives aimed at containing the crisis helped to restore calm to the market and lured foreign securities investment funds back to the Tokyo market.

The nine stimulus packages taken since August 1992, in combination with the infusion of public funds, totaling 120 trillion yen, boosted the cumulative total of debts of the central and local governments to 645 trillion yen at the end of fiscal 2000 (March 2001), or 130% of the nation's gross domestic product (GDP). This will exacerbate structural problems related to the mass accumulation of public debts as mentioned in (6).

Policy initiatives so far taken by the government are characterized by 1) too much delay in the expansion of fiscal spending as anti-recession measures and in the Bank of Japan's initiation of monetary policy, 2) a delay in

Ratio of population by age and child population



Source: Management and Coordination Agency

addressing structural problems as mentioned from (3) to (8), and 3) the focus on total demand for conventional anti-recession measures. In other words, the government has failed to take measures that go beyond cyclical measures (1) and the disposal of bad loans (2).

This is why the sense of occlusion prevails over the Japanese economy and society, with the result that fiscal and monetary demand stimulus measures have proven far less effective than in the past.

The average rate of growth of GDP expected by Japanese corporate executives in the next three to five years has continued to decline since the 1960s when it was in the 10% range. It sagged to 5% in the 1970s, to 3.8% in the 1980s and went further down to 1% in the eight years since 1992 when the current recession started. The continued decline in the expected growth rate bolstered corporate

executives' feeling that their companies are burdened with excess capacity and too many workers, prompting them to intensely cut down on capital investment and eliminate a large number of jobs.

Declines in the expected growth rate set off a vicious spiral, because when negative capital investment continues on the assumption of lower expected growth, actual economic growth continues to fall and even the growth potential of the Japanese economy deteriorates. The vicious spiral finally stopped in 2000 and the expected growth rate rebounded.

In regard to (4) and (5), Japan must prepare itself for global mega-competition against the background of the yen's appreciation and the remarkable increase in industrial production in developing countries where wage levels are still low. The average wage of Japanese workers in dollar terms has been at the highest level in the world since the late 1980s. This means that Japan will lose its competitive edge due to a cost handicap, if it only produces what other countries can produce.

What Japan must do to address the situation is to severely manage costs. But there is a limit to cost management, and thus Japan must continue to create commodities and services which have high added value and competitiveness. This necessitates the introduction of new wage and employment systems under which the capabilities of talented personnel can be fully tapped. At the same time, Japan must reform school and corporate education systems in such a way as to focus on creativity. It will also be important for Japan to drastically reform its taxation system with a new sense of value, because taxation acts as an incentive in the distribution of resources.

(7) is an issue which concerns significant changes in the nature of

industrial technologies driving the world economy in the new millennium. Industrial technology, which symbolizes the 20th century, is said to have been introduced by Henry Ford. The new technology, known as "Fordism," which involves the use of conveyor belts, enabled mass production of automobiles at low cost. It was a mass production technology based on standardization and specification. Japan achieved phenomenal economic development in the 20th century thanks to its creation of various systems that perfectly suited Fordism-type industrial civilization.

However, Japanese companies and Japanese social systems are now being forced to adjust to a new technological paradigm as a result of the emergence in the late 1990s and fast development of information technology and information-intensive industries. Represented by the Internet, they will become the mainstream of the new millennium.

(8) concerns Japan's response to a rapid change in population demography. A continued decrease in the number of children will cause an extreme shortage of young manpower in the future. At the same time, a sharp increase in Japan's elderly population will wreck the nation's fiscal structure unless it is properly dealt with, and higher tax burdens could result in a revolt by the younger generation. The economy would weaken and unrest would prevail in society. With the number of children decreasing and its aged population increasing at the fastest pace in the world, a prompt response will be essential to forestall such a situation.

Structural reform must be accelerated to rid Japanese people of the feeling of occlusion. The pace of reform will determine the form Japan will take in the long term.

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