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Japan's Slow-Motion Transition

ARTHUR ALEXANDER

As Prime Minister Shinzo Abe completes his first year in office, Japan's economy is doing well, with gross domestic product per person growing faster than 2 percent annually—a healthy rate by rich-country standards. Abe, however, has had little to do with this outcome. His policies have focused on improving Japan's relations with its neighbors and promoting some rather old-fashioned ideas: reintroducing patriotism into education, revising the postwar constitution to facilitate a more assertive foreign policy, and raising the status of the defense agency. Ironically, as the prime minister has returned to themes last seen in the 1930s, the nation is moving away from the economic system constructed during the 1930s to mobilize for war. It is doing so, however, in a managed and controlled way—which is to say, slowly.

In contrast to the United States, Japanese tend to make decisions in a more collective manner at higher organizational levels. Although decision-making styles overlap, the central tendencies are different: Japanese politicians and bureaucrats often are charged with adopting changes that in the United States would be driven by impersonal competitive imperatives. The consequence for Japan is that change is more likely to be political, bureaucratic, and delayed.

Flowing from these differences, Japanese often look to the United States and other countries for hints about new directions. An example from the past was the rise of IBM and its dominance of the market for large computers. Countries like Japan and France attempted to mimic IBM's results rather than the process that produced them. Both countries designated companies and worked with them to challenge IBM. This same approach is visible in the most recent proposals from the Japanese cabinet's economic advisory panel. The panel has noted the impact of information technology in transforming American industry and the weakness of this development in Japan. But rather than finding ways to enhance competition that would force companies to adopt more efficient methods, the government's advisory council has sought to copy the results by searching for specific regulations or laws that might be impeding adoption.

The result of this approach is that Japan tends to lag world leaders. A Japanese novelist captured this predicament almost 100 years ago. Natsume Soseki wrote that attempts to pursue progress must be accompanied by frustration because the standards of progress come from the West, not from within. Each time Japan achieves an objective, a new one is imposed and the Japanese, who do not even fully comprehend the old one, are left behind. According to this reading, the world is seen as something "out there" and a continuing source of anxiety. Perhaps more than at any time since the 1930s, "out there" economically is now at home. But, much as it took Japanese leaders 20 years to recognize the end of their country's high-speed growth, the internalization of the forces now driving change in Japan's economy may also take time to be recognized.

In fact, Japan's economy is evolving in fundamental ways, passing simultaneously through three separate transitions. The longest post–World War II expansion is now in its sixth year. The financial sector, debilitated by an asset boom in the late 1980s and its subsequent collapse in the 1990s, is nearing recovery. And, finally, the country is beginning to change institutions and habits left over from the wartime command economy. Retracing these transitions can help us project where Japan's economy may be headed next.

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THE MOBILIZATION ECONOMY

Japan's approach to economic affairs was shaped by the circumstances of the establishment of the modern Japanese state in the Meiji Restoration of the 1870s, which overthrew the 250-year rule and isolation of Japan by the Tokugawa clan shoguns. The feudal lords who led the creation of the new regime wanted urgently to erect defenses against Europeans and Americans. Defense required the development of industrial capabilities to supply a modern military force. The centrality of defense led to the dominance of the military in government and the primacy of military objectives in policy making.

Motivated by the logic of expansionist imperialism, and drawing lessons from World War I and its large-scale fighting, Japan's military strategists saw the need for mobilization planning, led by the military itself and by like-minded government bureaucrats. Mobilization staff promoted the idea of government authority over economic affairs in wartime. These ideas were put into practice with Japanese industrial development in Manchuria, coordinated by mobilization bureaucrats.

As the old system winds down, Japan is becoming more of a nation of winners and losers.

As Japan's war in China expanded in the 1930s, the government chose to impose economic controls to allocate resources rather than rely on markets to do the job. After Japan attacked the Pacific territories of the United States, Great Britain, the Netherlands, and others in December 1941, counterattacks on Japanese transportation networks and industrial facilities intensified supply shortages and increased the need for effective planning. Military planners and government administrators turned to an increasingly controlled economy, taking advantage of the experience they had gained just a few years earlier in Manchuria's government-led industrialization.

Production, however, fell short of targets. Attempts to expand output led to the examination of corporate governance and the adoption of the munitions corporation law of 1943, which changed the crucial requirement of the commercial code that corporate executives be the agents of the shareholders; instead, executives were responsible for achieving production goals based on directives emanating from government. Directors were selected independently of shareholders; management experience in the firm would be the chief criterion for appointment. Profits were no longer to belong solely to shareholders, but would be allocated to shareholders, workers, and directors.

The finance ministry designated one financial institution to fund each munitions corporation, taking into consideration previous business relations in the assignment. The financial institutions were expected to provide long-term as well as the customary short-term funds in a timely and straightforward manner. Until the late 1930s, large Japanese companies raised most of their funds by retaining earnings, by selling shares in the company, and by issuing bonds. For large corporations, bank loans accounted for no more than 15 percent of total funding. This picture changed in the mid-1930s, particularly among firms supplying the military. Within 10 years, the ratios were reversed, with banks providing the bulk of companies' financing needs.

The web of wartime controls and restrictions changed economic behavior in fundamental ways. Dividend payments, for example, which had averaged 60 to 80 percent of profits until 1937, fell to 30 percent in 1944. The downward trend continued in the postwar years, when the average payout fell below 10 percent. The ideas, methods, and institutions that came out of the war continued to influence public policy for several more decades.

The wartime attempt at mobilization planning, however, was not very effective. A postwar evaluation noted that the desired unification of plans, capabilities, and production was never achieved. Problems were numerous: the military services operated independently of each other and of government coordinators; industry administered allocations and priorities without reference to government directives; orders and supplies were never balanced; production was consistently overestimated; and critical priorities related to weapons production were never observed.

THE POSTWAR LEGACY

Japan's heritage of war was personal misery and economic chaos. At least 2.7 million military personnel and civilians, out of a population of 74 million, died as a result of the war. Millions more were injured or became sick. In addition to the atomic bombing of Hiroshima and Nagasaki, more than 60 cities had been heavily bombed, rendering 30 percent of the population homeless. One-quarter of the nation's wealth was destroyed, including four-fifths of shipping, one-third of industry's machine tools, and almost one-quarter of motor vehicles and railroad rolling stock.

The Americans arrived in Tokyo in September 1945, following Japan's surrender, with several economic objectives. At the top of the list was the dissolution of Japan's military capabilities, including its war industry. Other priorities were eliminating the country's large family-owned combines, reducing economic concentration, and encouraging labor unions. Occupation staff in Tokyo implemented extensive land reform.

The occupying powers introduced an impressive list of changes, including a shift in the locus of sovereignty from the person of the emperor to the people, the emperor's renunciation of divinity, extension of suffrage to women, revision of the legal codes, renunciation of war in the constitution, and a reformed education system.

However, one of the occupation's major and lasting effects on the Japanese economy was largely inadvertent. A pre-surrender decision by the wartime allies left the existing Japanese government in place to implement the policies of the conquering nations. In particular, US economic directives to continue wartime wage and price controls and to create an economic planning agency to direct economic reconstruction reinforced Japanese bureaucrats' own inclination to arrange economic affairs as well as their disinclination to trust markets.

Wartime industrial coordination was not a strange idea to American bureaucrats. In both World War I and World War II, the US government created agencies to manage military production, allocate materials, and control prices and wages. The lesson learned from this experience was that government had the obligation and capacity to coordinate vast enterprises in times of crisis. A broader lesson, drawn from the conspicuous breakdown of the economic order in the Great Depression, was that government provided an alternative to markets.

Ironies abound in the economic story of the American occupation. Japanese government officials expected the occupiers to dismantle the web of wartime economic controls; in the first weeks after the end of fighting, the officials had begun this task. The economic bureaucrats were surprised when the first Americans on the scene told them to maintain price and wage controls and, a few months later, to establish a planning agency. Perhaps the most surprised were Japanese businessmen who welcomed the invaders as like-minded capitalists. They were shocked to be confronted with New Deal philosophy, corporate dissolution, and extensions of the wartime controls.

Indeed, the occupying powers left in place many of the economic institutions and structures erected during Japan's march to war. Most important for the course of future economic developments was the preservation of bank-centered finance and the legal structure of corporate governance. In combination, these two institutions dethroned both shareholders and profitability from their premier positions influencing corporate behavior.

They also formed crucial parts of the Japanese postwar economic system. This system consisted of the following main elements: bank-centered finance; corporate governance featuring managerial control, oversight by main banks, and weak shareholders; networks of businesses centered on a key group company, or a large manufacturer and its suppliers, which often owned stakes in one another as a means of obtaining financing and mutual security; reduced price competition, including cartels, both legal and informal; internal labor markets with a commitment to so-called lifetime employment; and tight regulation of key sectors along with industrial policy that promoted specific industries. These elements formed an interlocked system with mutually reinforcing parts, which gained additional strength from their consistency with cultural norms.

Despite government's key role, any sense of an overall economic vision for the country quickly lost coherence. As in many other countries, government planners and regulators often became the pawns of politicians and of the industries and companies they were supervising. Internal battles for dominance within the government apparatus further weakened any sense of coordinated influence. Nevertheless, bureaucrats' inclination to distrust markets continued to influence written and unwritten regulation and guidance.

THE REFORMS BEGIN

Japan's classical postwar economic system began gradually to change in the 1970s. The process would occupy the next 30 years and is still ongoing. The first moves occurred in the tightly bound financial system. When the government incurred large fiscal deficits in the 1970s, it was forced to relax its interest rate controls to make government debt attractive to financial institutions. Also, as Japanese companies ventured abroad, particularly after further liberalization of foreign exchange in the 1980s, they found that they could raise funds in London more cheaply than in Tokyo and that the range of financial products was much broader in foreign centers. In 1984, the Tokyo manager of a large American financial company told me that he sold a hundred products in New York, but only two in Tokyo—stocks and bonds.

Financial market innovations, deregulation, and the substantially increased scale of international financial flows in the 1980s turned London, New York, Hong Kong, and Singapore into global financial centers. Tokyo lagged far behind, largely because of remaining regulations. Finally, businesses' desire for more diverse and less expensive financial services and foreign demands for greater openness, as well as Tokyo's loss of prestige among financial centers, led Prime Minister Ryutaro Hashimoto in 1996 to announce a "big bang" scheme of financial market deregulation, phased in over several years through 2001. A new Financial Services Agency was split from the Ministry of Finance to supervise the liberated financial sector. These changes helped end the system of bank-centered corporate finance, especially for large firms.

The urge of Japan's policy makers and politicians is to preserve old arrangements, to subsidize declining industries, and to underwrite regions with few prospects.

The shift of corporate funding from banks to capital markets also helped drive corporate governance reform. As business ties to banks weakened, it was now more important for shareholders themselves to monitor companies in which they were invested. More corporate law revisions occurred in the 1990s than in the previous 100 years. Business oversight and monitoring were strengthened in 1993, under pressure exerted by the United States during trade negotiations, by reducing the costs of initiating shareholder suits and allowing collection of damages. From 1950 to 1990, shareholders in Japan filed fewer than 20 suits against directors. By 1999, there were 286 such suits before the courts.

These changes resulted in a thorough revision of the commercial code, culminating in a new corporation law that took effect in May 2006. The new law embraces a reversal of regulatory philosophy: in the past, everything that was not specifically allowed was prohibited; today, everything that is not specifically prohibited is allowed. Under the new system, managers are freer to act as they see fit, but the law greatly expands the rights of shareholders, the need for disclosure, and corporate accountability.

Among the many consequences of these changes is rising competition for corporate control. The number of mergers and acquisitions has increased to levels that would have been unthinkable as recently as the mid-1990s. Moreover, the number of foreign companies taking over Japanese firms, counted in single digits in the 1980s, has surpassed 100 per year since 1999. Although successful hostile takeovers are still infrequent, they are increasing at a fast rate, from only a single recorded case in 1995 to 53 in 2005.

DELAYED REACTION

The evidence seems clear that at least the corporate finance and governance elements of the old wartime system have slowly dissolved. Nevertheless, banks remain central to smaller firms; lifetime employment persists, although the nominal allegiance to it is fading; and even though managers are responding to shareholder interests with greater alacrity, many companies are openly hostile to demands to foster the financial interests of their owners.

An important feature of the Japanese economy's slow transition is that it has largely been a bottom-up process. Although political leaders have intervened on occasion with strategically important policies—Hashimoto's financial big bang or Prime Minister Junichiro Koizumi's bank cleanup measures, for example—for the most part, the changes have been responses to shifting economic conditions faced by businesses at home and abroad. Absent is the heroic, political-economic transformation wrought, for example, by a Franklin Roosevelt or a Margaret Thatcher. A consequence of this political-bureaucratic response is that change occurs at a measured pace and tends to be relatively independent of who is prime minister. Nevertheless, a political leader who emphasizes liberalization and markets legitimizes and perhaps strengthens the forces of change, as compared to one who insists on maintaining the status quo.

Arguments persist as to whether the planning and guidance exercised by the Japanese government in the years immediately after the war contributed positively or negatively to postwar reconstruction and growth. If these policies and approaches held the economy back, the net impact could not have been very large, considering the rapid pace of reconstruction and subsequent expansion. However, most observers tend to agree that since the 1970s, even as the system has been unwinding, the old approach has acted as a drag on the economy. The demise of the wartime legacy, therefore, should have positive implications for future growth.

Banking errors

During the postwar years of reconstruction and high-speed growth, companies scrambled to keep up with demand by building new factories and getting them running, hiring and training new workers, and rounding up the funds to finance expansion. The talents rewarded in these efforts and the routines learned by managers and their bankers became embedded in the norms and expectations of business and finance. As growth slowed in the 1970s, however, those experiences had diminishing and then negative value, but another 20 years were to pass before behavior would adapt to the new circumstances.

The nation is moving away from the economic system constructed during the 1930s to mobilize for war.

The natural inclination to continue with successful methods was reinforced by the highly regulated banks, which made money from the spread between deposits and lending rates—a spread guaranteed to be profitable for even the weakest banks, as the Ministry of Finance administered a convoy system of bank regulation in which all banks sailed together, charging the same rates to customers for similar products and paying the same rates to depositors. It was a system with few financial products, little innovation, and no bank failures. This environment produced bankers who did not know how to evaluate business plans or assess risk. The consequence was overinvestment and low returns.

From the mid-1970s, Japan's businesses and government failed to recognize and adjust to decelerating growth. Businesses overinvested, hired too many employees, and borrowed too heavily. Banks lent too freely to over-leveraged customers. Then, in the late 1980s, a property and stock market bubble encouraged even greater excesses of lending and borrowing, but the bubble popped and prices collapsed starting in 1990. Borrowers could not repay their loans; they became nonperforming, in the language of bankers. Japan's economy stalled.

The financial authorities were complicit in allowing banks to cover up nonperforming loans. As the central government incurred ever-growing deficits, largely because the weak economy caused revenues to fall, the authorities were reluctant to use aggressive stimulatory fiscal measures. The Bank of Japan, confronted by the deflationary pressures of excess supply and weak demand, was late in recognizing the problem and reluctant to use what it regarded as unorthodox monetary policies.

The above list of problems confronting Japan's business executives, political leaders, and government bureaucrats would have challenged decision-makers in any country. In a country not known for its lightning reaction speed, the response was particularly slow. Nevertheless, almost all the problems had been reduced or eliminated by 2005.

What happened in Japan is not unique. World Bank economists in 2003 surveyed banking systems around the world since the late 1970s and counted up 117 systemic banking crises (defined as exhaustion of almost all bank capital). These crises had occurred in 93 countries, including many of the most advanced economies. Japan's banking crisis, in fact, followed a common path for such events. They usually begin when a highly regulated and protected banking system undergoes gradual deregulation. This, combined with rapidly changing financial technology, puts banks on a path of long-term decline because they are squeezed at both ends—by borrowers seeking better terms in deregulated credit markets and by savers looking for higher returns. In response, banks seek new customers, often lower-quality borrowers, relying even more heavily than before on collateral (especially real estate and liquid assets such as company shares).

Japan's regulators, bankers, politicians, and investors had little experience in dealing with the new phenomenon of risky and nonperforming loan portfolios. They all had incentives to wait for the economy to improve and for asset prices to rise. Thus, they collectively engaged in a strategy of "crossed fingers," wishing for the best and following a policy of forbearance.

When property prices did not rise, but entered a decline that would last for 15 more years, a new and dangerous stage of the crisis unfolded: evergreening. Japanese banks lent additional amounts to borrowers to cover interest and repayments. Outstanding loans to real estate and construction industry borrowers continued to climb until 1998.

Two events occurred that finally forced Japan's political leaders to pursue solutions. At the end of 1997, several major financial institutions failed, despite attempts by Ministry of Finance officials to rescue them. These events shocked everyone into a realization that the entire financial system was in danger. Banking laws passed in 1998 under Prime Minister Keizo Obuchi played a major part in resolving the immediate problem of banks running out of capital.

The second event was the selection of Koizumi as prime minister in 2001. Breaking with his Liberal Democratic Party, the political party in power most of the time since 1955, Koizumi appointed as his economics minister a professor of economics, Heizo Takenaka. At the end of September 2002, Koizumi reassigned Takenaka to head the banking watchdog. Takenaka directed major banks to reduce their nonperforming loans. They drew down their bad loans from more than 8 percent of outstanding lending in 2002 to 1.5 percent in September 2006 by writing them off their books and restructuring viable borrowers. Banks were forced to pay for these measures by reducing capital, which put many banks at or below required minimum levels. Smaller, regional banks, however, were not pushed as hard by the regulators to clean up their books. They improved, but as of September 2006 were running several years behind their big-city brothers with 4.4 percent of their loans still delinquent.

Delay in addressing the banking problem was costly to the government and to the nation. A World Bank estimate has put the fiscal outlays required to pay insured depositors and rescue failing banks at 24 percent of GDP, compared to an average of 15 percent among countries facing banking crises. The bank-associated slowdown in Japan's economic growth chopped an estimated 48 percent from GDP (totaled over 12 years), considerably greater than the average 12.5 percent.

IN RECOVERY

Although it required several decades after growth slowed in the 1970s, Japanese corporations finally recognized by the mid-1990s that the miracle growth economy had ended. They slowed their investments and reduced their capital stock by scrapping and writing off capital, or by allowing depreciation to reduce its value.

Japanese companies also had borrowed too much. Non-financial companies' loans and bonds as a ratio to sales almost doubled after 1980. Businesses finally started to reduce their borrowing after 2000. By devoting cash flow to debt payback, companies reduced their debt ratios to 1960s levels over the next six years.

Investments and loans were not the only things that Japanese companies had acquired too much of. Despite economic stagnation in the 1990s, companies had continued to hire staff at a high rate. It was not until 1997 that they realized that projected sales did not warrant such high numbers of employees. Once the process of labor force reduction began, it took another five years until companies reached a desired level.

As banks eliminated bad loans and raised new capital, and as companies gained control of their finances, investments, and costs, rates of return on capital began to rise after 50 years of decline. And in the past five years Japan's economy has responded with sustained growth. Over the so-called lost decade (1991 to 2002) price-adjusted GDP grew at an annual rate of only 0.9 percent, anemic even by rich-country standards. Since 2002, annual GDP growth has averaged more than 2.2 percent. There are few indicators that this expansion will end soon, although all do come to an end.

WINNERS AND LOSERS

Over the past 50 years, most Japanese have tended to rise and fall together, mostly rise. As the old system winds down, Japan is becoming more of a nation of winners and losers—across regions, industries, firms, and individuals.

Across Japan's regions, over the past 10 years, almost 2 million people have moved into Tokyo and its three neighboring prefectures, including 800,000 into the capital itself. Outlying regions have seen equal declines. These shifts have affected land prices, which had declined for 14 years after 1991 in every prefecture and for every type of property. Lately, falling prices have been far from uniform. In the past two years, land prices have dropped 13 percent on the northern island of Hokkaido. They have actually risen by 14 percent in central Tokyo.

Among Japan's industries, only a few since 1990 have contributed to the growth of the entire economy, while a significant number have been in long-term decline. For comparison, from 1970 to 1980, 11 industries out of a total of 42 accounted for two-thirds of aggregate growth; from 2000 through

2005, only 2 industries—electronics and business services—accounted for the same proportion.

Japan used to be noted for a remarkable stability among company rankings. One example is in retailing. The sales ranks of the 10 largest general merchandise stores showed extraordinary constancy over the 15 years ending in 1998. Among the top five companies, only mild shuffling occurred. In a comparable American sample, two companies appeared in the top ten that had not even existed a decade earlier, and Wal-Mart had jumped to number one from the seventeenth position. Revisiting the Japanese list in 2006, two major retailers had gone bankrupt and were acquired by other retailers. Two others flirted with bankruptcy; one of these came under the control and management of Wal-Mart while a Japanese company bought the other. These changes in ownership and control were accompanied by large-scale store closures. What is occurring in Japanese retailing is beginning to look like the American model.

Considering the increased differentiations across firms, industries, and regions, it should not be surprising to find similarly rising diversity among individuals. Japan in the 1970s reputedly possessed the most equal income distribution of all advanced countries. According to several surveys conducted by the Japanese government, using three different definitions of income, inequality declined until the 1970s and has risen since.

Two things are responsible for some, but not all, of the rising inequality: the aging of Japan's population and the rise of non-regular employment. Older people's incomes are lower than the working-age population's; therefore, as their share of the population grew from 10 percent in the mid-1980s to 17 percent in 2000, inequality increased. The growth of non-regular employment is a new phenomenon. These workers accounted for 19 percent of employed persons in the early 1990s but more than 30 percent in 2004. They receive lower wages and fringe benefits and work fewer hours than so-called regular workers, thereby widening disparities within the working population.

A study from the University of California at Berkeley using taxpayer information on individuals shows that the income share of the top 5 percent of Japanese taxpayers has risen sharply since 1980, swelling by 5 percentage points to almost a quarter of all income. Unlike in the United States, however, the story in Japan is not the super-rich at the very top of the income pyramid, but rather those just below the top; the gains in Japanese income shares appear only in the 95th to 99th percentiles. The very top tier of Japanese taxpayers has not increased its piece of the economic pie, as the corresponding American tier has.

It is not yet clear if greater variability of fortunes is a temporary adjustment to more liberalized constraints, or a permanent feature of a less fettered economy. Since variability has been growing since the late 1970s, it is probably not temporary, but reflective of a different kind of economy. Importantly, these changes predate the policies of Prime Minister Koizumi, although many observers link increased differentiation to his tenure.

A future with greater variability will require policies that encourage mobility of people and capital so that new opportunities can be exploited and unprofitable ventures abandoned. However, the urge of Japan's policy makers and politicians is to preserve old arrangements, to subsidize declining industries, and to underwrite regions with few prospects. That approach to dealing with differentiation will become more costly in the future than it has been in the past because there will be fewer resources to distribute as well as more cases of decline, even as new possibilities arise.

THE PREFERRED PACE

Japanese are engaged in a serious debate about their economic future. One book that has sold in the millions advocates a return to an idealized past before the country opened to the outside world in the mid-1800s—a world imbued with the samurai spirit and a less brutal form of economics. While these romanticized visions of the past engage many seeking an economic system consistent with their notions of Japanese values, businesspeople and politicians are striving to enhance Japan's economic capabilities and global position. Even so, they are not reluctant to build defenses against hostile takeovers or foreign interlopers. The accumulation of changes over the past 30 years suggests that there is no returning to a mythical history, but that the economy will continue to evolve toward an Anglo-American model, albeit one with Japanese characteristics.

This approach includes manifest fairness to potential losers, time to adapt, and reluctance to engage in confrontation. However, managing change in such a way, and incompletely at that, leaves the country at risk from a world that is changing even faster. As the Japanese manage economic adjustment at their preferred pace, they may be left even further behind than when they started, despite real progress over the past decade. ■