

## Which "Recipe" for the Japanese Economy?

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*"Quick fix" recipes for Japan's economy are as fallacious as cultural pessimism. It remains a fundamentally strong economy: per capita income at US level, huge household savings intact, cutting-edge technologies. Like Germany's economy, it is maturing, beset by a shrinking demography and molded by 130 years of reliance on indirect financing. Policy problems are cyclical and structural. The bubble, induced by misguided US pressure after 1985, was ruptured with dogmatic brutality, the resulting debt deflation mismanaged until March 2002. But Koizumi's reform has recovered strategic pragmatism: short-term anti-deflation measures, medium-term reform of banking structures, long-term public debt reduction, backed by improved division of powers in government.*

Having written about the Japanese economy in the 1980's, I am occasionally asked what would be "my recipe" for Japan's economic policy today. I hesitate to respond to such inquiries. I feel that it would be presumptuous of me to suggest that I have an immediately effective recipe for curing the present ills of the Japanese economy just like a doctor prescribing some new wonder drug to his patient. But I am also ready to challenge any economist, Asian or Western, lecturing economic policy makers in Japan or elsewhere that there is one economic policy instrument capable of overcoming deflation, eliminating massive public debt, eliminating private debt in the hands of overextended banks, stimulating consumption and optimizing the allocation of amply available capital at the same time. I submit that any such lecturing is methodologically flawed. Obviously, a plurality of targets is involved in the current debate and, hence, according to standard theory of economic policy, a plurality of instruments required. The problem is to link these in a functional hierarchy and in a sequence, or overlap, of different time horizons, one for each instrument.

Just as evidently, this case has political and social dimensions which go beyond the methodology of main stream economics. Economic policy-making, itself, is dependent on the functioning of government. If there are persistent difficulties of economic policy, there may be problems in the functioning of government. As it happens, Japan's Prime Minister is determined to include a reform of the functioning of government in his economic strategy and a majority of public opinion — remarkable by any Western standard — supports that determination.

In democracies, such reforms do not happen over night, however. They cannot be ordered from the top. Opposition needs to be won over by means of persuasion, vested interests be reckoned with. In Japan, this is particularly so within the ruling party itself. The Koizumi reforms can hardly be judged on the basis of one year. Just two comparisons: the "Reagan revolution" of US budget policy was shifted by Con-

gress on the reverse track of a Superkeynesian deficit before balance was attained a decade later (by the Clinton administration...). The privatisation of the German Post took 15 years.

With these reservations in mind, I propose to attempt a diagnosis before discussing conceivable "recipes". First, let us not jump to cultural explanations for Japan's present ills. Unfortunately, that is what many Western, and even some Japanese, observers seem to do. But that would be like the attitude of a doctor who, by condescendence or weariness dismisses his patient's pain as "psychosomatic". Today's problems of the Japanese economy are by no means essentially "Asian" problems, nor particularly "Japanese" problems, just as Japan's outstanding economic performance from the mid 1950's to the mid 1980's was not a miraculous achievement of the unscrutable Far East.

Remember the end of the 1980's? At that time, it was fashionable to believe in the "Asian Miracle". The headlines were "Decline of America" and "Rise of Asian Capitalism". Since capitalism as such could not very well decline in one part of the world and rise in another, failure and success were conveniently associated with the adjectives "American" and "Asian" respectively. Excess liquidity in the US capital markets was led by what Alan Greenspan later called "irrational exuberance" to pour into Asian stock markets.

When challenged by unbelievers, the headline writers marshalled academic support from Asian experts with a culturalist bent. The "Confucian" explanation of the Asian miracle was born. Little did it seem to matter that some of Asia's economies were located in Islamic Indonesia, Malaysia and Pakistan, in Hindu India, in Buddhist Thailand, in the Christian Philippines or in a country like Japan where Shinto, Buddhist and Christian creeds pragmatically coexist with Confucian ethics, often all in one household.

When Thailand devalued the Baht in July 1997, the opinion makers hastened to turn around by 180°. Confronted with a frenzied flight of Western capital out of Asian stocks into American bonds, the talk in media town was of "Asian failure" as opposed to America's job miracle, balanced budget, high tech and "new age economics". Previously vaunted "Confucian" virtues were now decried as vices, in most cases reinterpreted as patterns of corruption.

Using a common standard for both Asian and Western economic performance, both failures and successes, one cannot count on many allies. In the 1980s, my husband and I explained the economic performance of Japan and some other (by no means all!) Asian countries as "More Western than the West".<sup>1</sup> We argued that these economies stood out in terms of a wider spectrum of economic theories competing with each other in Western dogmatic discourse than did leading Western economies, and more particularly the US, Germany and France. With such a universalist critique of the prevailing culturalist view, we had to resign ourselves in remaining a minority voice.

<sup>1</sup> Michèle Schmiegelow and Henrik Schmiegelow, *Strategic Pragmatism: Japanese Lessons in the Use of Economic Theory*, New York: Praeger, 1989; id., "Obei Ijoni Obeitekina Nihon Keizai", in: *Chuokoron* Vol. 108, No.1 (January 1993), p. 72-83.

Ten years later, I applied again the universalist standard in commenting on the so-called "Asian Crisis".<sup>2</sup> At least I did not have to turn around by 180°. I proposed to use the same methodology in comparing present economic failures to past successes of some of the Asian economies involved. I argued that it was worthwhile to compare functions and dysfunctions of a country's policies and structural patterns in times of crisis as much as in phases of boom. I proposed to examine whether policies had remained sound in terms of the theory of economic policy and whether structures previously considered as comparative advantages of some Asian countries, such as levels of education ("human capital"), degrees of income equality or disparity, demographic factors, resource endowment or scarcity, saving and investment propensities continued to be present or had gone away, or while still present had no longer functional benefits, but turned out to be a dysfunctional liability.

I am in favour of a similar approach to analysing the problems of Japan's economy since the end of the 1980's. I submit that while some structural patterns such as demography also turned from functional strength to liability, the most severe problems developed in economic policy-making since the mid 1980's.

In the three decades up to the 1980's, Japan's economic policies had excelled in what my husband and I have called "Strategic Pragmatism". A wide spectrum of cyclical and structural policies represented an impressively complete application of the full range of Tinbergen's theory of economic policy:

- Keynesian demand management, since the early 1980's pragmatically combined with moderately monetarist monetary policy,
- Colbertist industrial policy throughout the three decades,
- gradual trade liberalization since the 1960's,
- a superbly successful guidance of projects of pre-competitive research co-operation of five leading electronic firms on main frame computers and memory chips in the early seventies, which triggered what was later aptly called the "electronics revolution",
- a remarkably determined ecological policy since the mid seventies, and
- a courageous attempt at reducing fiscal deficits and public debt in the early 1980's for the sake of gaining a margin for future pensions of the rapidly aging population.

Japanese policy-makers seemed to have the awareness that such a wide spectrum of targets and instruments was subject to trial and error, required frequent functional feed-backs and implied working with very different time horizons.

Strategic pragmatism as displayed in such an economic policy spectrum requires the realization that human knowledge is fallible, and, hence, scientific theories subject to refutation. But it does not treat such scientific uncertainty as an excuse for inaction. It acknowledges that inaction may be riskier than action. At the same time it realizes that adjustment and correction is imperative as soon as failure is recognized.

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<sup>2</sup> Michèle Schmiegelow, "'Asian Capitalism': Explanation of Failure as well as Success ?", in: *ASIEN* No. 70, January 1999, pp. 54ff.

In terms of philosophy, pragmatism means to eschew dogmatism. Rather than aligning practice with theories adhered-to for their own sake, pragmatism puts theories in the service of practice as problem solving devices following the method of trial and error. Philosophical Pragmatism is more than "muddling through". It is the translation of the scientific standard of critical rationalism into economic policy, technology policy, ecological policy, and business strategies.

In economic policy, strategic pragmatism means to actively consider what the competing schools of thought of economic theory have to offer without falling to them in dogmatic blindness. I believe that an important part of Japan's problems since the second half of the 1980's is that its economic policy has become an arena of competing doctrines. Often, such contention appeared as spill-overs of dogmatic battles in the US or Europe.

Many agree that Japan's present woes are in one way or the other consequences of the "bubble". But, strangely, there is not much discussion about how the bubble was caused. I submit that it was caused by the "Super-Keynesianism" of the 1985 Plaza Agreement obliging Germany and Japan to help correcting the US trade deficit by letting their currencies appreciate and by expanding their domestic economies at the same time. The US added pressure on Japan to expand domestic demand by both fiscal and monetary means. The resulting Maekawa reports meant shelving the long term strategy of public debt reduction just adopted and pursued for a few years by Prime Minister Nakasone. The Bank of Japan followed Alan Greenspan's massive monetary expansion after the 1987 stock market crash. Exchange rate up, interest rates down, fiscal deficit up: if there was ever an intoxicating policy mix, it was this. The bubble was inevitable.

Then, suddenly, the Bank of Japan seemed to be wanting to be more orthodox than the Bundesbank. Changing tack to rigorous monetarism, it abruptly raised interest rates in December 1989 and, a more severe blow to Japan's banks, abolished window guidance, the most important channel of liquidity to them, in June 1991. The bubble burst and the long agony of debt deflation, the first since the crash of the Österreichische Kreditanstalt in 1929 and the subsequent world depression, began. It seemed as if Japan was about to repeat that most Western economic crisis including Hoover's single-mindedness in reacting to it.

If there is just some truth in this diagnosis, then at least one basic prescription suggests itself quite evidently: it is desirable for Japan's economic policy to disentangle itself from dogmatic battles, especially from those waged elsewhere, and to recover the strategic pragmatism that seemed to come so naturally to its policy-makers up to the mid 1980's.

Of course, important structural changes have occurred in the meantime as well, and policies inspired by strategic pragmatism today must evidently take these changes into account. Japan's economy has long matured and now, in addition to coping with deflation, needs to take the very typical structural problems of mature economies in its stride. One such problem, the demographic decline already mentioned, is widely recognized.

Another, very important one, seems to have been overlooked so far, which is astonishing in light of the current debate on Japan's banking sector. It concerns the balance between direct and indirect financing. Banks tend to play a far less prominent role in mature economies than in "catching-up" economies. Alexander Gerschenkron explained the bank financed development of the two classical 'catching-up' economies of the late 19th century, Germany and Japan, in his "paradigm of backwardness".<sup>3</sup> In Germany, the shift from indirect finance to direct finance began imperceptibly in the 1980's. Today, Germany's leading private banks tend to see their future in investment banking leaving the collection of household deposits largely to local saving banks. In Japan, the bubble brought perhaps the last heady days for old style banks. But it may have been just an artificial delay before their traditional role in financing and controlling industrial development had to fade away anyway.

A third problem of mature economies is saturation of demand for housing, roads, bridges, and other infrastructure projects of the building sector. This sector is often associated with local 'pork barrel' politics, in the US and Europe just as in Japan. And since, as Theodore Roosevelt famously stated, 'all politics is local', structural change in the building industry typically brings about political pain that filters through the national level. Prime Minister Koizumi's efforts to rid budget policy of the special interests of the building industry is a timely response to the maturing of the Japanese economy.

However, apart from these sequels of maturing, Japan is still a fundamentally very strong economy by any Western standard. It is still the second largest economy after the US with a per capita income at par with the US, the largest creditor country of the world, the country with the greatest pool of household savings of the world, a country boasting entrepreneurs of Schumpeterian quality leading firms that set global benchmarks in their sector, a technology location where wise American and European firms consider it necessary to be present to preserve their own competitiveness.

Some say, because of these endowments, Japan does not really feel the pain of its problems. I think that is a fallacy. Japan does worry, if we can believe opinion polls attesting popular yearning for reform. Some, like the authors of 'Chinbotsuron', worry too much.

I argue that even mature and fundamentally strong economies like Japan can be in need of, and will respond functionally to, policies inspired by strategic pragmatism. And as far as I can see, the Koizumi government is on a remarkable course to such a strategy.

The Cabinet's anti-deflation policy made a significant breakthrough in March 2002. For almost the entire first year of the Koizumi government, there was dogmatic

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<sup>3</sup> Alexander Gerschenkron, "Typology of Industrial Development as a Tool of Analysis" in: *Second International Conference on Economic History*, Paris: Librairie Mouton, 1965, pp. 449ss. For a functional explanation of the interplay of indirect finance and government support in catching-up economies see Charles Kindleberger, *Economic Response, Comparative Studies in Trade, Finance and Growth*, Cambridge, Mass.: Harvard University Press, 1975, pp. 19ss.

dissension among Japan's economic policy leaders on whether deflation is a monetary problem amenable only to monetary solutions, or a result of structural shortcomings calling for structural changes. Policy-makers in charge of economic, fiscal and structural policies espoused the former view, leaving the job of coping with deflation to the Bank of Japan. Conversely, the Bank of Japan defended the latter view, passing the parcel back to the agencies in charge of structural policies, especially regarding the banking sector. It was a debate sounding extremely familiar to anybody following economic policy discourse in continental Europe. By mid March 2002, however, the Prime Minister had succeeded in prodding all agencies involved, including the Bank of Japan, to cooperate in a strategy combining monetary, fiscal and structural instruments.

This new readiness for a comprehensive approach did not mean the end of dogmatic struggle. While cooperating in the monetary field by making ample liquidity available to the banking sector, the Bank of Japan continued to believe that the main problem was structural. This became evident in October. In a move intended to challenge the government to take more drastic action in improving the capital base of the banking sector, it took the unprecedented step of buying shares from banks out of their industrial portfolios. Prime Minister Koizumi responded within days: he asked the head of the Financial Services Agency in charge of supervising the banks to quit and added that responsibility to the portfolio of the most radical reformer in his cabinet, the minister for fiscal and economic policy, Heizo Takenaka.

However, while enjoying the confidence of the Bank of Japan as a determined reformer, Takenaka, in turn, challenged the Bank of Japan by advocating the adoption of an inflation target for monetary policy as a means of overcoming deflation. Takenaka thus offers a remarkably comprehensive policy mix combining structural and anti-cyclical elements.

While leading LDP politicians criticize him as an academic ready to ruin the economy by dogmatic rigidity, he is in fact much more pragmatic than many of his colleagues in the economic profession. Initially, he may have been too much inclined to administer a hard landing for the banking sector. His public statement upon assuming the charge of banking supervision, that "No bank was too big to fail", was certainly a mistake if avoidance of a banking crisis was considered to be one of his responsibilities. For a while, the odds were against his political survival. But Koizumi held on to him and at the beginning of 2003 both are still in office. Takenaka's merit remained that his proposals transcended the frontiers between structural and cyclical arguments.

In fact, this bridging of dogmatic cleavages was called for both in terms of theory and the realities of the situation. For the deflation besetting Japan is a very composite phenomenon, neither exclusively monetary, nor exclusive structural, but certainly both. In fact at least four different origins of Japan's current deflation can be identified with relative ease:

1. the debt deflation left over from the bubble:

The phenomenon of debt deflation was first and last analyzed by Irving Fisher in the 1930's who prescribed monetary policy as a cure. But it is also a challenge to prag-

matic policy-makers to find carefully timed and measured forms of relief for debtors and banks combined with incentives for an in depth overhaul of the banking sector.<sup>4</sup>

2. technology-induced deflation:

This pattern was present in the 1930's as well. At that time, the assembly lines brought steep price declines. Today, information technology has a similar effect, especially in a technologically leading country like Japan. This is a definitely non-monetary phenomenon, which no government in its right mind would try to combat, yet filters into national price statistics.

3. deflation induced by 'locational competition':

Foreign locations offering lower costs of production attract domestic industries to produce abroad and sell such lower cost products at home. In Japan, this is currently summed up as 'China deflation'. Entire sectors of Japanese industry such as the once highly competitive optical industry have moved much of their assembly to China. The mercantilist policy-response would be competitive currency devaluation, a better one the regional economic integration which the Koizumi government is in fact actively promoting. Exchange rate policy as explained by former Vice-Minister Kuroda as well as his successor Mizobuchi has been limited to correcting previous over-valuation of the yen. It may have been extended to leaning against the wind of dollar depreciating news from the US.

4. the so-called deflationary spiral:

It is caused by consumers waiting for ever further price declines before deciding to spend. The text book response, suggested to Japan by Joseph Stiglitz among others, would be not monetary but fiscal, i.e. previously announced temporary increases of consumption taxes. This type of measure is so unpopular anywhere in the world that no government would take it lightly. Since Japan has a very low level of consumption tax by European standards there would be a reasonable margin for such a measure. The government may yet have to consider it if consumer behaviour does not turn around autonomously. For the time being it seems wise to keep that powder dry.

Strategic pragmatism can be discerned in the composition and time horizons Japan has chosen for the fiscal and monetary policy mix, the problems of the banking sector, and the reduction of public debt. In the short term cyclical area, fiscal policy is assigned a neutral, monetary policy a stimulating role, as should be the case under conditions of debt deflation. The most distinctive feature of budget policy is its departure from previous patterns of 'Keynesian' public works programs pleasing the building industry and instead an emphasis on alleviating social hardships. Monetary policy, having exhausted its interest rate instruments and having limited the exchange rate instrument to correcting previous overvaluation of the yen is now focusing on case by case liquidity infusions to avoid a banking crisis.

The trap of a dogmatic 'either/or' choice between anti-cyclical and structural policies can only be avoided by a sequence of short-term time horizon for anti-cyclical policies and medium-term goals for structural policies. This is what the Koizumi

<sup>4</sup> Irving Fisher, "The Debt-Deflation Theory of Great Depressions", in: *Econometrics*, Vol. 1, 1933, pp. 337ss.

government seems to have in mind. Having decided not to trigger a banking crisis intentionally with further heavy deflationary cost, it had to put structural reform of the banking sector on a medium term track. This would allow the fittest banks to survive in a process of natural selection over the next few years. There could be a competition between them in identifying new core competences and to train their management for the changed role of banks in mature economies. Already now it can be observed that some are much further along that road than others. In January 2003, Goldman Sachs decided to buy US\$ 1,2 bn worth of preferred shares of Sumitomo Mitsui Financial Group, raising the capital adequacy ratio way beyond the Basle minimum, no small sign of confidence in the fundamental resilience of the Japanese economy. At the same time, however, the future of smaller sectoral or local banks remains to be safeguarded as a safety line of credit for small and medium enterprises.

A resumption of the policy of the early 1980's to reduce public debt will obviously only be possible after debt deflation has been absorbed, after the banking sector has recovered structural health and after the economy has regained the path of growth. Given the size of Japan's public debt, its reduction to manageable proportions can only be a longer term goal, the last to be attained in the sequence the Koizumi government had to decide when it came into office.

For the Japanese economy to grow as a mature economy, it needs to change its methods of capital allocation that were designed — and worked extremely well — for a catching-up economy. Capital continues to be amply available. Japan's household saving rates as percentages of disposable income ranged between more than 20% in the 1970's and more than 12% in the 1980's and 1990's as opposed to the US range of between less than 10% and 6% respectively. Just as a warning against falling into the culturalist trap, I have to add immediately, however, that European economies, especially Italy, France, and Germany show saving rates very similar to those of Japan. The 'odd man out' in terms of saving behaviour is definitely the US. Japan's present problem is putting these savings to productive uses.

The bulk of Japanese household savings is deposited with the public Postal Savings Office, with more than 3 trillion US\$ the largest pool of such savings in the world. In the past, these savings played a historic role as they were channelled by off-budget fiscal policy to infrastructure and development projects of the Fiscal Investment and Loan Program (FILP). Since the need for such projects declined in the maturing process of the Japanese economy, a considerable part of the functions of the FILP and hence of the public Postal Savings system has disappeared. Japan's huge pool of private savings capital is now underutilized in its public form of deposit.

Of course, it is remarkably safe there. The risk aversion of the proverbial grandma' who has put her spare yen in her savings account at the nearest post office, with hindsight appears particularly 'rational' in times of deflation, because it is 'cash' which has gained in value while real assets have lost in the past decade.

But certainly, once deflation will be overcome, more functional methods of capital allocation have to be developed. In this context, Prime Minister Koizumi's campaign for the privatization of Japan's Postal System gains a salient significance for Japan's



future as a mature economy. It meets vigorous resistance of special interest within his own party. But in an interview with the *Financial Times* he compared his campaign with the conquest of Osaka castle in the middle ages. The privatization of the letter services of the Post was just like the filling of the outer moats. The taking of the keep would be the privatization of the Postal Savings Office. This is strategic pragmatism in a nutshell.

Of course, grandma's risk aversion will have to be considered in privatizing postal savings. A particular regime of banking supervision may have to be designed for a private post bank in Japan. It might be worthwhile to decentralize at least part of the management as well as the supervision of such a post bank so as to offer local savers a greater sense of 'nearness' along with the added advantage of greater competition between national and local banking services. There may be useful functional links between thinking on decentralization and thinking on privatization among the reformers.

The most ambitious target of the Koizumi strategy is evidently the reform of the functioning of government. As discussed above, from an economic point of view, this is not only an end in itself, but could serve as a necessary instrument for setting Japan on course for growth as a mature economy. Mancur Olson explained Japan's post-war rise by the fact that after the defeat it was less ruled by special interests than the victorious Anglo-Saxon countries.<sup>5</sup> In the subsequent four decades of prosperity, it may have lost that advantage. One sure way to combat the rule of special interests is to combat non-transparent relations between individual law-makers and individual decision-makers of the executive branch of government. Such non-transparent interference was highlighted case of Muneo Suzuki, former Diet Member, Parliamentary Viceminister of Foreign Affairs and influential power broker of the Hashimoto faction of the LDP, who had used his LDP power base to exert extraordinary influence on the working level of the Ministry of the Gaimusho, including the use of funds, routinely bypassing the Minister. The Prime Minister confronted him openly, triggering his resignation, expulsion from the Diet and indictment for corruption. The best cure of such intransparencies is a clearer separation of the legislative and the executive branches of government. The place for transparent interaction between them is the parliament. This recipe is a very old and tested one: the separation of powers. In his efforts at political reform, Prime Minister Koizumi has a founding father of constitutional thought at his side: Montesquieu.<sup>6</sup>

<sup>5</sup> Mancur Olson, *The Rise and Decline of Nations: Economic Growth, Stagflation and Social Rigidities*, New Haven, Conn.: Yale University Press, 1982.

<sup>6</sup> The classical source of the principle of division of powers in government is: Charles de Montesquieu, *Baron de la Brède et de Secondat, De l'Esprit des Lois*, Paris, 1748. See also Anne M. Cohler, *Montesquieu's Comparative Politics and the Spirit of American Constitutionalism*, Lawrence, Ka: University Press of Kansas, 1989. On the problems of interlocking connections between the legislative and executive branches of government in Germany (just as in Japan) see the chapter on "Gewaltenverschränkung zwischen Parlament und Regierung", in: Detlev Merten, Hrsg., *Gewaltentrennung im Rechtsstaat: Zum 300. Geburtstag von Charles de Montesquieu*, Berlin: Duncker & Humblot, 1989, pp. 77-89.