

Japan

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Japan is the second largest economy in the world after the US. Japan's rapid economic recovery since the second world war has been remarkable. Today, the country has a broad range of capabilities in various industries. And its per capita income is one of the highest in the world. Yet, Japan's prolonged recession, which started in the early 1990s, is raising major concerns. In this three part series on Japan, the Global CEO examines the various challenges facing Japan. In the first part of the series, we look at the historical circumstances under which Japan has evolved. We also take a brief look at Japan's economic crisis and the problems arising out of demographic changes.

The Evolution of Modern Japan

Early History

The Japanese archipelago assumed its present shape around 10,000 years ago. Soon after, the era known as the Jomon period began and continued for about 8,000 years. Its people were hunter-gatherers. Gradually, they formed small communities. They also started using earthenware objects. Rice cultivation reached Japan around 300 BC.

Japan took its first step to nationhood in the Yamato period, which began at the end of the third century AD. During this period, the ancestors of the present Emperor brought a number of small states under unified rule from their bases around what are today, the Nara and Osaka Prefectures.

In 604, Prince Shotoku laid down Japan's first constitution. Buddhism began to take root in Japan. The country's first permanent capital was established in Nara. Toward the end of the century, the capital was transferred to Kyoto. The Heian period began, during which noble families predominated and a distinct national culture blossomed.

Feudal Age

The victory of the Minamotos marked the virtual eclipse of the imperial throne as the source of effective political power and the beginning of seven centuries of feudal rule under a succession of shoguns, (military rulers).

In 1192 Yoritomo, head of the victorious Minamoto family, established the shogunate, (military government), at Kamakura, near present-day Tokyo, and assumed some administrative powers that had previously been held by the Emperors in Kyoto. The shogunate encouraged austerity and the pursuit of the martial arts and disciplines which had become necessary to restore effective control throughout the land, especially over restive clans in remote provinces. The Kamakura period, as the age of Yoritomo's shogunate is called, was an era in which bushido, the way of the samurai, or Japanese chivalry prevailed.

In 1213, real power was transferred from the Minamotos to the Hojos, the family of Yoritomo's wife. They maintained the military government in Kamakura until 1333. During this period, the Mongols twice attacked northern Kyushu, once in 1274 and again in 1281. But the Japanese successfully held the field and prevented the invaders from penetrating into the interior. Following the destruction of most of their fleet by typhoons, which struck on both attempted invasions, the Mongol forces withdrew from Japan.

A short-lived restoration of imperial rule, from 1333 to 1338, was followed by a new military government established by the Ashikaga family at Muromachi in Kyoto. The Muromachi period continued for more than two centuries, from 1338 to 1573.

After two centuries of rule, the shogunate in Muromachi found its authority being challenged by rival clans in other parts of the country. Towards the end of the sixteenth century, Japan was torn by civil

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wars as provincial lords battled for supremacy. Order was finally restored by the great general Toyotomi Hideyoshi in 1590.

In 1592 and 1597, Hideyoshi launched two invasions of Korea, both of which eventually failed in the face of Korean and Chinese resistance. His work of pacifying and uniting Japan was consolidated by Tokugawa Ieyasu, founder of the Tokugawa shogunate. It was during this transitional period of civil wars that many of Japan's most famous castles were built.

A Period of Isolation

Having established himself as the effective ruler of Japan, Ieyasu founded his shogunate in Edo, as Tokyo was then known, in 1603. This was a major turning point in Japanese history. Ieyasu made a significant impact on Japan's political and social institutions, for the next 265 years.

To preserve the integrity of the social and political structure that Ieyasu had erected, the Tokugawa shogunate virtually closed Japan's doors to the outside world in the middle of the 17th century. The shogunate realized that Christianity could be a potentially explosive power. Christianity was eventually proscribed. The shogunate also barred entry to all foreigners, except a handful of Dutch traders confined to the small island of Dejima in Nagasaki Bay, some Chinese living in Nagasaki, and occasional royal envoys from the Lee-dynasty of Korea. For two-and-a-half centuries these people were the only contacts between Japan and the outside world. They enabled Japanese scholars to acquire a basic knowledge of Western medicine and other sciences during the country's long period of isolation.

The Meiji Restoration

Japan came under increasing pressure towards the end of the eighteenth century to open up its shores to the outside world. In 1853, Commodore Matthew C Perry of the United States entered Tokyo Bay with a squadron of four ships. He returned the following year and succeeded in persuading the Japanese to conclude a treaty of amity with his country. Similar treaties were concluded with Russia, Britain, and the

Netherlands in the same year. These treaties were changed four years later to treaties of commerce, and a similar treaty was concluded with France.

The impact of these events accentuated the social and political currents that undermined the foundations of the feudal structure. There was great turmoil for about a decade, until the feudal system of the Tokugawa shogunate collapsed in 1867 and full sovereignty was restored to the Emperor in the Meiji Restoration of 1868. The Restoration marked an important turning point in Japan's history. A new system of government centered on the Emperor was set-up. The new government promoted modernization, adopted Western political, social and economic systems, and stimulated industrial activity.

Emperor Meiji transferred the imperial capital from Kyoto to Edo, the seat of the former feudal government. The city was renamed Tokyo, meaning "eastern capital". A constitution was promulgated, establishing a cabinet and bicameral legislature. The old classes into which society had been divided during the feudal age were abolished. The country began to show much more enthusiasm towards modern Western civilization.

The Meiji Restoration was like the bursting of a dam. It released pent up energies. But

unfortunately, some of them were channelized in the wrong direction, resulting in major international repercussions. Japan successfully waged the Sino-Japanese War of 1894-95. In the process, it acquired Taiwan from China. In the Russo-Japanese War of 1904-05, Japan once again emerged victorious, acquiring South Sakhalin. (Japan had ceded Sakhalin to Russia in 1875 in exchange for the Kurile Islands, and for having its special interests in Manchuria recognized.) Japan first made Korea its protectorate in 1905 and then annexed it in 1910. Emperor Meiji, died in 1912, before the outbreak of World War I. By the end of this war, Japan had become one of the world's great military powers.

Emperor Taisho, who succeeded Emperor Meiji, was in turn succeeded by Emperor Hirohito in 1926. The nation's industries continued to grow, and its political life seemed soundly rooted in parliamentary

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government. But the worldwide depression unsettled the nation's economic life. Public confidence in the political parties waned after a number of scandals came to light. Extremists exploited the situation, and the military clique took full advantage of the prevailing confusion. The influence of the political parties steadily declined. After the outbreak of war with China, the parties were forced to unite on a single platform of co-operation in the war effort. They were finally dissolved, and in their place was erected a United National party. With the Diet's functions reduced to little more than those of a rubber stamp, nothing could stop the tide of events that finally led to the outbreak of the Pacific War in 1941.

In August 1945, an exhausted and battle-weary Japan accepted the surrender terms of the Allied powers, and by imperial edict the people laid down their arms. For more than six years after the surrender, Japan was placed under Allied, mainly American, control. Under the Occupation authorities, led by General Douglas MacArthur, various social and political reforms were introduced. Agricultural land was redistributed in favor of former tenants. Workers were allowed to organize trade unions and to strike. Japan put into effect a new Constitution and committed itself to becoming a peace-seeking democracy. In 1951, Japan signed the San Francisco Peace Treaty, which signified its return to the community of nations as a reformed state. By this treaty, Japan regained its right to conduct foreign affairs, which had been suspended under the Occupation. In 1956, Japan's entry into the United Nations was approved.

Since 1945, Japan has enjoyed a remarkable degree of domestic political stability. Except for a brief period of socialist government in 1947 and 1948, the conservatives have retained their majority in the Diet.

Beginning with its admission to the United Nations in 1956, Japan became an increasingly active participant in international political as well as economic and social forums. The security arrangements with the United States, originally signed in 1951, were revised in 1960 to make them more reciprocal. War reparations were

Major Periods in Japanese History

Periods

Paleolithic period	pre- 8,000 BC
Jomon period	ca 8,000-ca 300 BC
Yayoi period	ca 300 BC-ca AD 300
Yamato period	ca 300 AD-593
Asuka period	593-710
Nara period	710-794
Heian period	794-1192
Kamakura period	1192-1338
Muromachi period	1338-1573
Azuchi-Momoyama period	1573-1600
Edo period	1600-1868
Meiji era	1868-1912
Taisho era	1912-1926
Showa era	1926-1989
Heisei era	1989-

paid off by the mid-1960s. After a prolonged series of negotiations, Japan established formal relations with the Republic of Korea in 1965. Thanks to its highly educated and abundant labor force and to the concentration of capital and resources in certain key

industries, such as electric power and steel, Japan succeeded in achieving rapid industrialization during the 1950s and 1960s. The Tokyo Olympics of 1964 symbolized the new confidence of the Japanese people and the country's increasing stature in the international community.

The reversion of Okinawa (the

Ryukyu Islands and the Daito Islands) from US administration to Japan in 1972 and rapprochement with the People's Republic of China in the same year were two other important events in the 1970s. In 1975, Japan became a member of the G7 group of industrialized nations.

Since the 1990s, Japan has been suffering from recession. The country's unemployment rate touched 5.6 percent in December 2001, the highest since World War II. In 2000, more than 19,000 companies went bankrupt. Consumer prices fell almost every month

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during the major part of 2000 and 2001. The deflation, the weak banking system and the seeming inability of Japanese politicians to come to terms with the problems, have all raised serious concerns. Much has been expected of Junichiro Koizumi, who recently became prime minister. But Koizumi will have to navigate carefully Japan's complicated political system to launch any meaningful reforms. Already, there are signs that Koizumi's efforts are getting inhibited due to the well entrenched power brokers.

Japan's Political Economy

Much has been written about the role of the government in Japan's economic development since the end of the second world war. But still, there are several misconceptions. A careful analysis is necessary to understand the role of the state in Japan's economic development.

Japan's affinity for state-directed economic policies is not a recent phenomenon. During the Tokugawa era (1603-1867), the shogunate tightly controlled most domestic activities ranging from transportation to commerce. Even when the Tokugawa shogunate was replaced by Emperor Meiji, the state's control of capital continued. The new rulers wanted a modern economy which could grow rapidly and catch up with Western countries. To facilitate the process, the Japanese government decided to take the necessary risks and pump money where necessary. Some of the wealthy merchants who had made their fortunes during the Tokugawa period led and partially funded the new enterprises, but they worked in collaboration with the state, not as independent entrepreneurs. They started the government-supported, family-run companies and banking houses (zaibatsu) that fueled much of Japan's growth in the first half of the twentieth century.

Japan resisted efforts by the postwar American occupation forces to liberalize capital markets in the late 1940s. As a result, its economy in the 1950s looked very much like it had in the 1930s, with the state appointed banks, and large companies working

together. The government soon established several financial institutions to apportion capital to companies and sectors it deemed important for economic recovery. The government-run banks included a long-term credit bank, an export-import bank, a development bank, a bank for small-business financing, a foreign-exchange bank, and even a bank for long-term lending to agriculture, forestry, and fishery ventures. The government began efforts to make Japan globally competitive by promoting specific industries such as steel, auto manufacturing, and consumer electronics for export. It also used the banks to subsidize small rice farmers and domestic food processors, protecting them from international competition.

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From 1956 to 1973, the Japanese economy grew at a spectacular rate of almost 10 percent a year. Technological innovations spurred the expansion of manufacturing facilities and sales of consumer durables like television sets, refrigerators, and automobiles. The economy showed its resilience

during the two oil crises of the 1970s. In response to the oil shocks, Japanese businesses developed fuel-efficient products and manufacturing processes. During the period 1973-91, the economy grew at a respectable 3.8 percent.

Gradually, Japan's industrial structure was transformed from one centered on traditional 'smokestack' industries to one focused on high-tech, electronic industries. Japanese products rapidly gained a reputation around the world for their high quality, reasonable prices, and energy efficiency.

But in recent times, things have not looked so good for the Japanese economy. Since 1991, Japan has suffered two outright recessions and growth has been negligible. In the late 1980s, Japan's bubble economy, inflated by exorbitant real estate values, collapsed. Many companies were unable to repay their loans due to failed investments and a deteriorating economy. At first, many banks attempted to hide these bad loans. But after a few years, some of Japan's biggest financial institutions found themselves on the verge of collapse. In November 1997, Sanyo Securities,

Hokkaido Takushoku Bank, and Yamaichi Securities went bankrupt. In an effort to propel the economy out of recession, the government recapitalized banks, used government guarantees to keep credit flowing to small businesses, and used fiscal stimulus packages. This has pushed the Japanese state's debt to ¥666 tn (\$5.6 tn), or 130 percent of GDP.

Between 1984 and 1992, job creation in *Japan* was just half the US rate. In 1998, there were only 47 jobs available for every 100 job seekers. The largest government-run job agency in Tokyo found jobs for only five percent of applicants. Due to globalization and outsourcing, these jobs may not be reinstated when the economy recovers. In the US, new economy industries, such as software and computer services, information, info-tech manufacturing and sales, communications, education, financial services, and consulting, generated bulk of the jobs. But in *Japan*, construction companies employ almost seven million people, or 10 percent of the nation's work force—double the percentage in the US. These jobs depend heavily on the government's public spending.

Prime Minister Ryutaro Hashimoto and his cabinet announced the 1996 "Big Bang" initiative to make the financial system more transparent and market oriented by loosening the insurance and securities sectors and providing tax cuts for corporations. The government also decided to restrict the regulatory powers of the Ministry of Finance by establishing the Financial Reconstruction Commission, the Financial Supervisory Agency, and an independent Bank of Japan. Despite some backsliding, the improved market access and reconfigured financial regulatory bodies created by the Big Bang allowed new entrants into the marketplace to challenge the former giants.

Notwithstanding all these initiatives, Japan's financial system is plagued by serious problems. The country's banks still has bad loans totaling at least ¥32 tn (\$266 bn). Most Japanese banks continue to extend new loans to debt-burdened companies, often in exchange for only modest restructuring plans. This has delayed structural adjustments. By keeping alive "zombie"

firms desperate to sell surplus production at any price, the banks have helped push prices down for two consecutive years. This deflation is worsening the economic crisis.

Until recently, the chief constraint on government spending was the MOF and its strict advocacy of fiscal prudence and debt reduction. But from July 1998, the government began to spend heavily on public-works projects. In November 1998, it finalized a \$206 bn emergency economic package, the largest stimulus in the nation's history. Around the same time, it prepared a budget that contained the biggest annual spending increase on record—a rise of 5.4 percent to \$771 bn. Two more supplementary budgets

followed in 1999. The 2000 budget featured a record \$810 bn in outlays. Prime Minister Obuchi, issued more government bonds than any other prime minister since 1965—the year in which bonds were first released. The 2000 budget brought his total up to \$800 bn, far surpassing the corresponding

figures for each of his 16 predecessors. Outstanding long-term debt, which included both national and local government debts, rose to \$6 tn, or 1.3 times Japan's GDP—a per capita debt of about \$48,000.

The government launched nine mammoth stimulus packages, totaling \$1.2 tn, between 1992 and 1999. The modest growth in the first half of 1999 was fueled entirely by state largesse. Aggregate demand rose directly in line with increases in public-works spending. But when the effects of the pump-priming wore-off in the third quarter of 1999, Japan slipped back into recession. A substantial portion of government spending, went to keep inefficient public-works contractors on life support. Meanwhile, the flow of cash from banks to small businesses slowed to a trickle.

The decision to increase government spending has definitely been influenced by the political objectives of the LDP. The expenditure has kept thousands of small construction companies afloat and their more than six million employees engaged in government-funded public works around the country. The 2000 budget, for instance, is dominated by traditional

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construction projects, such as extensions of the shinkansen bullet train to less-populated areas of Tohoku and Kyushu. The public-works portion of the overall budget is too high. Japan has a higher ratio of paved to unpaved roads than in the United States. But almost 30 percent of annual public-works outlays still go towards roads.

Meanwhile, Japanese politicians are introducing some desperate measures in the country's weak financial system. From April 1, 2002, Japan will see two major changes. Banks will mark to market the prices of the equity shares they hold.

The government will also roll back the blanket bank deposit insurance that it introduced in 1998. Meanwhile, the Nikkei index of share prices reached 10,000 in February 2002 (compared with about 40,000 in 1989.)

The prolonged economic crisis has been the growing conflict of interest within the business community, and the lack of persistent pressure on bureaucrats and politicians

Crisis in the Political System

Public confidence in Japan's Government has been at an all time low in recent times due to various policy failures. The bureaucracy's reputation has been tarnished by the various corruption scandals involving elite officials. The chronic inability of Japanese politicians to come up with tough solutions when they are most needed has disappointed the public. The ruling government coalition, led by the LDP, has spent more time in political power games than in developing long-term solutions.

The policies announced since late 1999 have raised concerns about the commitment of the government to the reform process. A good example, is the decision to amend a new public nursing-care insurance scheme, thereby lowering the financial burden on the elderly. Based on the new plan, premium payments by people over the age of 65 would be delayed for six months, with a plan to phase in payments over one year at just half the amount needed to meet program costs. The shortfall of \$9.5 bn would be covered by government borrowings, further delaying the introduction of a financially viable scheme.

It is becoming increasingly clear that, Japan's scandal plagued and opaque political system is totally inconsistent with the country's status as one of the most developed economies in the world. Japan's political and administrative structure just does seem to be equipped to embrace radical change. Within the LDP, vested interests (zoku) dominate the party's policy making committees and government ministries. The zokus' importance as party fund raisers and vote-gatherers ensures that their members rise up the LDP hierarchy and gain executive positions both in the party and in government—where special interests

can be championed at the highest levels. Zoku power helps explain the rigidity of public-works spending across the standard categories of expenditure—because zoku politicians make sure the MOF's Budget Bureau does not interfere.

Vested interests are also entrenched in the Diet, whose

members maintain their own personal support groups (koenkai). These groups serve as grassroots campaign machines. Interest-group leaders and local business owners are important members of the koenkai.

For bureaucrats, vested interests are institutionalized in the practice of amakudari—"descending from heaven". Bureaucrats retire from government ministries and agencies into executive posts in semipublic organizations and onto the boards of banks, industry associations, and big corporations. Systems of regulation require that corporations maintain good connections with regulators; hence the need to give posts to ex-officials who can provide access to the ministry.

A major contributing factor to the prolonged economic crisis has been the growing conflict of interest within the business community, and the lack of persistent pressure on bureaucrats and politicians in support of a policy program. The Japanese business community seems to be divided by tensions between companies and industrial sectors that favor deregulation and those that oppose it, those that favor market solutions for financially distressed

industries and those that favor strong government intervention and support.

The Economist (February 16, 2002) recently remarked: "Japan's vested interests do not merely frustrate reform through unpopular votes in the Diet. They also command much of the machinery through which ideas are evaluated and turned into legislation. If a prime minister wants to challenge them, he has little chance of even bringing a good alternative up for a vote. That makes it harder for the Japanese voters to vet recovery plans clearly and make their wishes known."

A Changing Society

It looks surprising that the Japanese have put up with stagnation for so long. This is a society, which has been famous in the past for facing dire challenges head-on. After its devastating defeat in World War II, the country reinvented itself remarkably well to become one of the most economically advanced nations in the world. But now, there seems to be an air of resignation and helplessness. A careful analysis reveals several reasons for this phenomenon.

In the past, the Japanese were always too poor to pursue individual solutions to economic problems and thus relied on the state to support their group efforts. Given this dependence on government, Japanese citizens had a strong incentive to make themselves heard, ensuring that the state adopted wise policies. Now they are affluent enough to pursue private solutions to their economic problems.

The famous economist Albert Hirschman has distinguished between pressures for change that result in disgruntled parties withdrawing from the system ('exit') and those where parties voice their grievances and try to work within the system ('voice'). In competitive markets, when customers stop buying a company's products, profits start to fall and the market forces the company to exit the business. But, in other less market-oriented systems, people work within the system and attempt to solve problems in a co-operative manner.

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The organizational structure that Japan developed after the war was more similar to an suburban school system than a market. The state developed excellent channels of communication with business. These were enhanced as retired bureaucrats took on top positions in firms and private industry associations helped implement policy. Corporations heavily dependent on state help also had every incentive to keep channels of communication open from their end. Needing to develop real competitive strengths, especially if they hoped to succeed in international markets, Japanese companies made sure government policy did not stray too far from the dictates of the market.

Over time, however, Japanese industry, especially the most competitive firms has become wealthy enough, and less dependent on the state. Firms such as Toyota and Sony, have for some years financed most of their investments out of retained earnings. They neither need state financing, nor they are dependent on the domestic capital markets. They can go to New York, London, or any number of other financial centers to mobilize funds. In other words, the most competitive segment of Japan's industry no longer has much incentive to improve the efficiency of the country's financial system.

The increased globalization of Japanese firms has opened up additional opportunities to get around government policies. Responding to rigidities in the labor-market, rich Japanese firms have relocated their operations abroad. The unco-ordinated exit of Japanese firms has only aggravated the nation's long-term economic problems. With the most competitive firms locating their high-return investment projects abroad, domestic capital is being channelized into much less efficient investments.

At an individual level, changing social norms have encouraged the 'exit' tendency. By increasing their private savings to make up for possible cuts in pension benefits, individual Japanese have made it more difficult for the government to get the economy back

on track by boosting consumption. Twenty years ago, few Japanese families had the resources to support their children once they reached working or marrying age. Young men left home as soon as possible and found a corporate job, whereas women married at a young age. In contrast, today many parents earn wages generous enough to support or subsidize adult children who remain at home. Fewer sons or daughters face financial pressure to marry, and some do not even feel much obligation to go to work.

In the past, conservative social norms limited career choices. Women, were expected to marry, leave their jobs, and have children. Today, however, highly educated Japanese women have the opportunity to hold well-paid jobs and to opt out of marriage altogether. Thanks to today's greater freedom and the financial ability to take advantage of them, the Japanese public has become more likely to try to escape the nation's problems rather than force the government to address them.

As *The Economist*¹ has put it, "This apparent acceptance among the general public as well as the political old guard, of a long, slow decline is rather sad for a once-vibrant nation, but not all that surprising. Life during the decline is by no means terrible; public services and infrastructure are good, people are affluent, families are strong. And the alternative is far from easy".

The Aging Problem

An issue which is raising serious concern is Japan's aging society. No nation has ever aged as rapidly as Japan. Even the United States, for all its warnings about an impending Social Security and Medicare crunch, is expected to reach 2025 with 3.25 working-age adults for every retiree. Japan, on the other hand,

is facing a true crisis. Pensions and medical expenses for the elderly could push the share of government and social-insurance spending in the economy from 40 percent today to more than 60 percent by 2025.

To deal with its ageing problem, Japan has to take urgent measures. It needs to make it easier for women with children to continue working. Only half of working-age Japanese women currently hold jobs, and the proportion is even lower for mothers. Japan's current system — which offers limited child care,

inadequate parental leave, inflexible schedules, and long hours—makes women choose work or children, not both. By opting to be full-time housewives, women deprive the economy of their paid labor. At the same time, those who choose work and put off or opt out of marriage and children contribute to the

country's shrinking birth rate.

In 1999, the country's total fertility rate fell to 1.34 children per woman of child-bearing age, a record low. If Japan is to cope with the aging of its population, it needs many more women to choose both work and children. But this will require expanded government programs and changes in the attitudes of employers, schools, and husbands. These are changes that may not be very easy for the Japanese to swallow. ■

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¹ February 16, 2002.