

Japan's Post War Economic Miracle

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Introduction

Following the atomic bombings of Hiroshima and Nagasaki in 1945, Japan formally surrendered to the allied forces on September 2nd, beginning just under 7 years of United States occupation and formalising the death of Imperial Japan. (Takemae, Eiji, 2002) The ensuing global geopolitical environment and the resulting foreign policy objectives of the United States would dictate the early trajectory of Japan's post war recovery. Soon after World War two, conflicting ideologies between the USSR and the United States caused tensions to grow and the onset of the Cold War. The United States' primary goal with the occupation of Japan was to first prevent the further spread of Communism, and second prevent Japan from being a future military threat. (Takemae, Eiji, 2002)

To do this, the United States chose to democratise and demilitarise Japan while implementing a host of economic reforms in order to reinforce the Japanese economy as a capitalist, free market economy.

Even before the onset of the second world war, Japan was a relatively developed country, with GDP per capita estimates landing around Eastern European countries and higher than the USSR (Madison Project, 2020). Japan had a fairly robust economic backbone and strong political and economic institutions. Reforms during the early part of the Meiji era also resulted in a westernised education system and a highly educated workforce. (George Alan, 1972)

The combination of these factors and policies altogether led to the rapid industrialisation of Japan through to the 1970s with Japanese living standards rising rapidly. By 1956, real GDP per capita had recovered to the levels reached in 1940. Between 1958 and 1974, the Japanese grew at 10% per year. (World Bank, 2024)

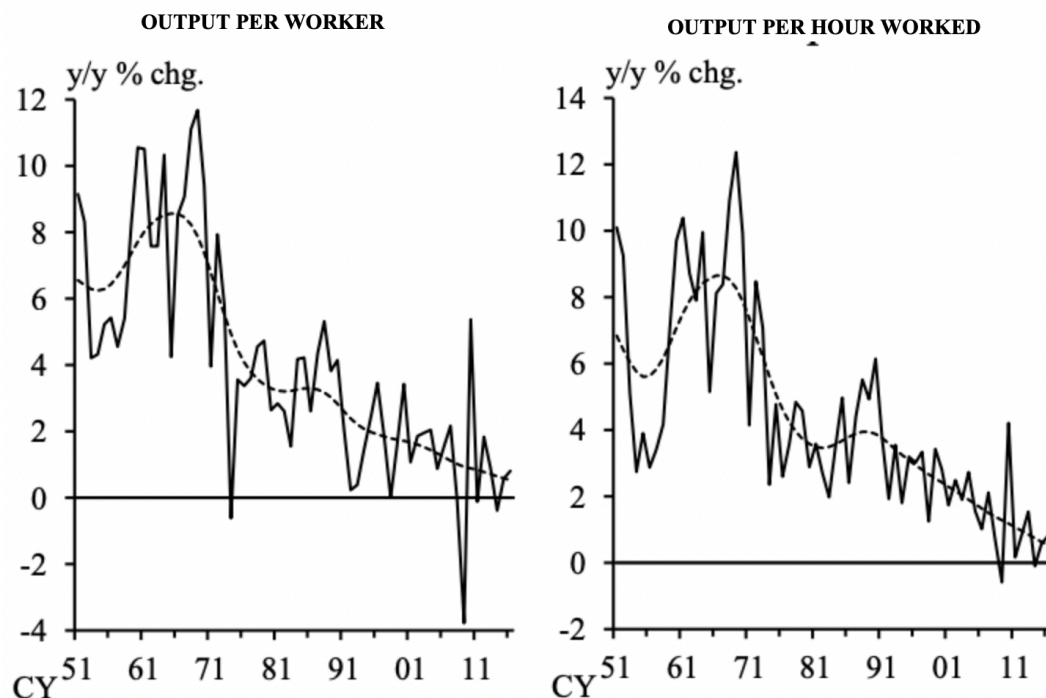
Democratic reforms

During their occupation of Japan between 1945 and 1952, the United States made a slate of economic and political reforms. Politically, the constitution of Japan was amended such that Japan became a democracy, moving sovereignty from the emperor to the people. It also renounced war as an instrument of state policy and enfranchised women. (Eiji Takemae, 2002) The occupation served to bolster the political institutions of Japan, combining aspects of a democratic and developmental state. The creation of a competent and meritocratic bureaucracy with the duty of centrally planning the

development of the Japanese economy, staffed by those most qualified for the job (rather than politicians), named the Ministry of International Trade and Industry (MITI) ensured the effective management of Japan's industrial policy, instilling a culture of long term development goals. The bureau was insulated from political pressures in order to focus on the growth of Japan's industry and the modernisation of its economy. (Chalmers Johnson, 1982) While Japan was a democracy, there was limited political pluralism with the Liberal Democratic Party maintaining nearly uninterrupted political power from 1955 onward. This ensured the efficiency and efficacy of economic policy by enabling a focus on long term growth rather than repeated changes in policy direction caused by changes in the ruling party.

The result is a suite of land, labour, educational and industrial reform policies implemented. Prior to 1947, much of Japan's productive agricultural land was held by large land owners. In the following two years over 5.8 million acres of land were bought back by the government and resold to at extremely low prices to the farmers that originally worked them, thus dismantling feudal power structures. By 1950 over three million tenant farmers had acquired land and just 10% of farms were worked by farmers who were not landlords. This served to reduce income inequality and rural poverty. Further, it incentivised farmers to maximise productivity on their farmland because they could keep the profits from the harvest as opposed to surrendering it to landlords. (Michael Hunt, 2013)

Labour reform resulted in the right of workers to strike and unionise. The goal of this reform was to ensure that "Working conditions shall be those which should meet the needs of workers who live lives worthy of human beings." Following the reform, there was a marked improvement in working conditions which also directly led to an improvement in labour productivity. Improvements in industrial relations resulted in more productive management structures, reduced labour disputes and increased worker morale, all of which led to rising labour productivity. Between 1951 and 1971 labour productivity as measured by output per worker grew at an average rate of approximately 8% per annum (see figure 1 and 2).



SOURCE: Bank of Japan, Productivity Improvement and Economic Growth, 2018

Figures 1 and 2

Industrial reform involved the dissolution of large family controlled industrial conglomerates called Zaibatsus in order to promote competition, reduce economic concentration and improve income inequality.

Ultimately, these reforms undertaken by the US occupation served to create an economic and political environment conducive to rapid economic development through the effective, accountable and transparent provision of public goods (e.g. education), economic institutions and economic policy.

State Led Industrialisation

To capitalise off of this newly created economic and political environment, after the signing of the treaty of San Francisco, the MITI began a concerted state led industrialisation effort. The goal of the MITI's industrial policy was to develop the productive capacity and capability of Japan's economy, moving the economy from producing low complexity to high productivity industries. In order to do this the MITI had to promote capital accumulation (both human and physical capital) and the transfer of technological knowledge from more developed and productive economies. The MITI acted to systematically remove bottlenecks in investment and capital accumulation, providing advice, guidance and formal incentives for Japanese industry to develop in

specific ways. The MITI would routinely form policy around modernisation, technology, investments in new plants and equipment, and domestic and foreign competition. The demilitarisation overseen by the US occupation had now also freed up substantial government expenditure that the MITI could direct to develop productive capacity.

One of the primary policies of the MITI was “Priority Production”, which involved the identification of emerging industries and industries in which Japan had a comparative advantage in order to selectively support those industries. It also took interest in supporting the raw materials and input industry which included producers of coal, steel and textiles. In essence, MITI promoted economic specialisation using a variety of financial techniques which will be discussed later.

Post war Japan was not as industrialised as other more developed nations and as such, initially could not compete with cheaply produced exports from other countries. Thus MITI took a protectionist stance in order to bolster infant industries by forcing consumers to consume domestically produced goods in those industries while also preferentially supporting them. Japan primarily used high tariffs to disincentivise imports of certain goods, but also used its mandate on exchange rate policy to peg the exchange rate preferentially, until it was floated in February 1973 in favour of monetary policy.

Infant industry protection is a controversial economic policy due to the variety of risks it poses. Infant industry protection will never pay off unless protections are slowly removed as the sector becomes internationally competitive. Protectionist policies to some extent will always distort the incentives in the market, whether it be in regard to pricing or in regard to investment and innovation. Most concerningly, corporate interests can lead to lobbying and corruption in order to maintain the protectionist stance. MITI struck a balance with its industrial policy by, one, ensuring that its protectionist stance was temporary, slowly winding down as industries matured; two, choosing only industries with clear positive externalities and future strategic interests to protect and three, insulating itself from rent seeking behaviour. It is also important to note that this policy stance may not have been as successful had it not been for the United States which tolerated Japan’s controversial trade practices and a constantly growing trade surplus through the 60s and 70s.

Japan’s post war financial system and accumulation of capital

The Japanese government and MITI were heavily involved in incentivising specific strategic industries to develop and they would do this through a variety of “hard” measures such as subsidies, grants, providing or withholding cheap loans, tax

concessions, government contracts, import permits and the control of the foreign exchange rate. The financial system and the government involvement in capital markets in particular was critical to the accumulation of capital.

Directly after the war, Japan lacked an adequate capital market to fund investment. As such tax policies incentivising households to save money in banks were introduced, increasing the capital supply and reducing the cost of investment borrowing for companies.

During this period, foreign direct investment, namely from the US for the purpose of arming the military for the Korean war helped to fill the investment gap. Still, there was a shortage of capital which was largely funded by the Bank of Japan (BOJ).

Corporate borrowers borrowed substantially beyond their ability to repay causing city banks in turn to over-borrow from the Bank of Japan. This dependence on the banking sector by Japanese Industry was what fostered the close partnership between the BOJ and MITI. MITI used the BOJ's funding as another policy instrument as it allowed the selective financing of investment in priority industries at lower rates than others. (Bank of England, 1981)

The Japanese market also culturally differed from foreign markets in that it tolerated profit reinvestment over dividends to a greater extent. Dividend payouts were also partially restricted to incentivise investment. This is evidenced when analysing the sources of capital used to invest in manufacturing, which is typically a very capital intensive industry. Between 1954 and 1980, internal financing, i.e. financing from reinvestment of earnings as opposed to borrowing or equity issuings grew from 22.4% of financing activities to 46.5%. (see table A)

Sources of funds in manufacturing industry

Percentages

	Fiscal years	1954-63	1964-73	1974-80
Internal				
Retained earnings		1.8	7.8	13.6
Reserves		2.9	5.9	4.8
Depreciation		17.7	23.0	28.1
Total		22.4	36.7	46.5
External				
Proceeds of stock issues		13.4	2.3	2.9
Short-term borrowing(a)		20.6	16.9	20.1
Long-term borrowing(b)		17.2	16.1	6.4
Accounts payable		14.6	15.4	8.2
Other		11.8	12.6	15.9
Total		77.6	63.3	53.5

Sources: Economic Planning Agency, Economic White Paper, 1976 (1954-63 and 1964-73).
Bank of Japan, Financial Statements of Principal Enterprises (1974-80).

(a) Includes promissory notes payable.

(b) Includes bonds.

Table A, Source: Bank of England, 1981

Changes in labour force

Following the war, there were a variety of beneficial changes to the Japanese workforce. In addition to the aforementioned labour reforms, there was not only a centrally incentivised accumulation of physical capital, but there was a large-scale investment in human capital to develop the quality and productivity of the labour force. Through the 1950s and 1960s there was a substantial increase in the number of universities in Japan.

MITI played a pivotal role in knowledge transfers from overseas by incentivising the imports of advanced technologies as well as the travel of academics to foreign countries to learn advanced production methods. (Qingming Song, n.d)

The US occupation had brought about not only political changes but a variety of cultural changes which resulted in the relaxation of Japan's patriarchal culture. Strong familial ties that prevented productive young workers from moving to economic centres for high paying employment were loosened. Women were also incentivised to enter the workforce. These policies, in aggregate, resulted in a larger, more educated and more

productive workforce which directly contributed to economic growth and the transition to knowledge based industries. (Helen McNaughtan, 2005)

Conclusion

Japan's industrial development was driven by a combination of factors that enabled its rapid economic growth and global competitiveness. The establishment of a highly competitive manufacturing sector laid the foundation for economic expansion, while deliberate industrial restructuring facilitated a shift toward higher-value, knowledge-intensive industries. Additionally, proactive trade policies enabled Japan to integrate into global markets, securing access to resources and consumers. This trajectory aligns with the broader concept of a "catch-up economy," where nations achieve rapid growth by leveraging knowledge transfer from more advanced economies. Japan's ability to absorb, refine, and improve upon existing technologies—rather than solely relying on innovation—allowed it to close the gap with leading industrial nations. Ultimately, this strategic approach positioned Japan as an economic powerhouse, demonstrating the effectiveness of industrial policy, technological adaptation, and global engagement in achieving sustained economic success.

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