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Miracle to Malaise: *What's Next for Japan?*

by W. Michael Cox and Jahyeong Koo

Just as it was being hailed as a dynamic model for development, Japan's economic miracle turned to malaise.

Japan's economy was once a world-beater. A prolonged period of rapid growth raised the country's per capita GDP from less than 20 percent of the U.S. level in the early 1950s to within 20 percent by 1991. A mere two generations after defeat in World War II, Japan had emerged as the world's second-largest economy and a major exporter of autos, consumer electronics, semiconductors and other advanced products. Books and studies extolled Japan as a paragon of the modern economy.

Just as it was being hailed as a dynamic model for development, Japan's economic miracle turned to malaise. By 2004, the country's GDP per capita had slipped to 71 percent of the U.S. level *(Chart 1A)*. From 1996 to 2002, per capita GDP inched forward by just 0.2 percent. In the 131 months from February 1991 to January 2002, Japan suffered 66 months of

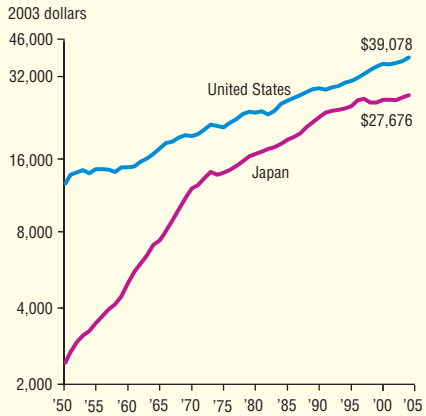
recession; the United States endured only 16.

Stagnation also gripped Japan's labor market. In the 1990s, the country's unemployment rose by nearly 3 percentage points, while the U.S. rate fell by more than 2 percentage points. This relative performance stood in stark contrast to the experience from the late 1950s through the 1980s, when Japanese unemployment typically ran 3 to 5 percentage points below the U.S. rate *(Chart 1B)*.

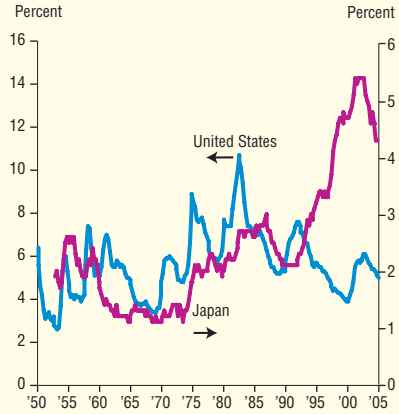
Japan's ills show up in the industrial sector, too. From 1953 to 1991, factory production increased at an

Neither insufficient demand nor tight monetary policy fully explains what went wrong with Japan's highly competitive economy.

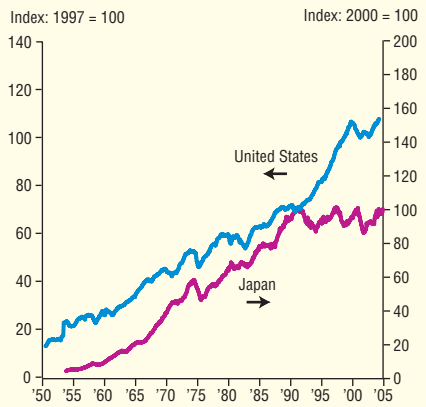
Chart 1
Japan vs. United States



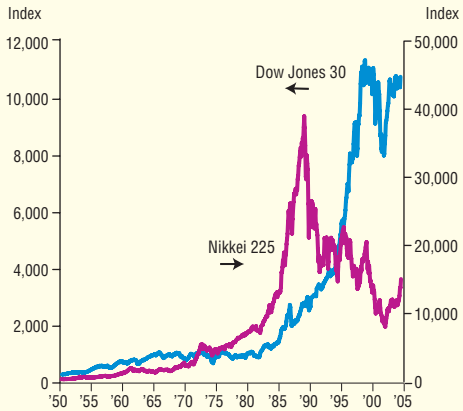
SOURCES: Organization for Economic Cooperation and Development; Bureau of Economic Analysis; Cabinet Office, Government of Japan; International Monetary Fund; Central Intelligence Agency.[1]



SOURCES: Bureau of Labor Statistics; Japanese Ministry of Health, Labor and Welfare.



SOURCES: Federal Reserve Board; Japanese Ministry of Economy, Trade and Industry.



SOURCES: Dow Jones & Co.; Nihon Keizai Shimbun.

[1] For GDP per capita 1950 to 1998: *The World Economy: A Millennial Perspective*, by Angus Maddison, OECD, 2001; BEA. For GDP per capita 1998 to 2004: BEA; Cabinet Office, Government of Japan; International Financial Statistics for population (1998–2003), IMF. For 2004 population, *The World Factbook*, CIA.

average 8.5 percent a year, compared with 3.1 percent for the U.S. Over the next dozen years, however, growth in U.S. factories accelerated to 3.3 percent, while Japan's industrial sector suffered three recessions that left its production index unchanged *(Chart 1C)*.

Financial market barometers reflect the tale of two nations. From its peak to its trough, Japan's Nikkei fell by nearly three-fourths, while the Dow Jones industrial average more than quadrupled *(Chart 1D)*. Real estate values followed a similar pattern. Prices of residential land relative to consumption fell by nearly two-thirds in Japan from 1991 to 2004, while doubling in the U.S.[1]

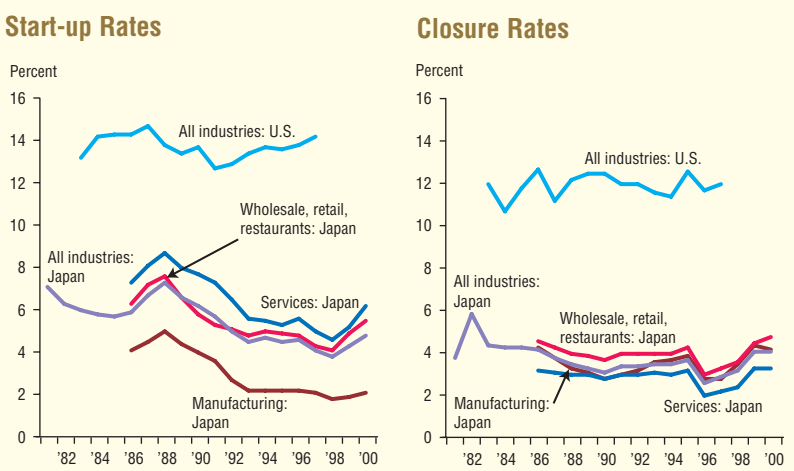
Strong economies sometimes endure rough patches, but Japan's long stagnation presents a conundrum. How could a once-dynamic economy experience such a long period of meager growth? Answering this question may well tell us whether recent signs of a Japanese economic revival indicate that a true recovery is at last under way. Better understanding Japan's experience might also provide insights into what makes economies succeed as well as offer policymakers some cautionary lessons.

Economists, of course, have analyzed Japan's economy to discern how it lost its way. Some have argued that the contraction was the result of insufficient demand, prompted by a fall in asset values as the real estate bubble burst.[2] This view, however, offers no fundamental rationale for the climb or fall in real estate values in the first place, relying on naïve and misinformed agents as a driving force. More important, it fails to explain why liberal doses of government spending didn't reverse the country's fortunes. Expansionary fiscal policies in the 1990s doubled Japan's debt relative to GDP, with an imperceptible impact on economic growth. Indeed, public spending has been decreasing in Japan for several years, yet GDP growth has been strengthening.

Other economists contend that the Bank of Japan's tightening after the fall in asset values caused the stagnation. This criticism—similar to one often heard about Federal Reserve policy in the 1930s—implies that a precautionary loosening of monetary policy was needed to counteract the economic effects of plunging asset values. Too-tight monetary policy from late 1992 through 1996 may be what exacerbated Japan's recession in the mid-1990s. It fails, however, to account for stagnation for years after the Bank of Japan embarked on a strongly expansionary monetary policy in the late 1990s.[3]

Neither insufficient demand nor tight monetary policy fully explains why a once-thriving, highly competitive economy might fail to respond to either fiscal or monetary stimulus. Much deeper problems hindered Japan, however, and a strong case can be made that the culprit was widespread impediments to economic change.

Chart 2
Business Closure and Start-up Rates in U.S. and Japan



SOURCE: "Sectoral Productivity and Economic Growth in Japan, 1970–98: An Empirical Analysis Based on the JIP Database," by Kyoji Fukao, Tomohiko Inui, Hiroki Kawai and Tsutomu Miyagawa, Economic and Social Research Institute, Discussion Paper Series, No. 67, October 2003.

Japan's Structural Constraints

More than a half century ago, economist Joseph Schumpeter wrote that economies evolve through a process he termed *creative destruction*, driven by innovation and expanding trade. Schumpeter's famous phrase captured the essence of capitalism: continuous change—out with the old, in with the new. When competing for customers, producers adopt new technologies, improve production methods, expand markets and introduce new and better products. All these activities roil the status quo, making some companies and workers obsolete while providing opportunities for others. Policies that discourage innovation and stifle competition prevent economies from replenishing themselves. In time, they weaken and recede, a consequence only hastened by connection to the global marketplace.

For most of its modern history, Japan resisted creative destruction by trying to tamp down capitalism's creation and carnage. As seen in Chart 2, for example, the country's business closure and start-up rates are a third to a half the United States', with the

When it needed to be more dynamic, Japan found its economy too high cost to compete with the Chinese and too inflexible to keep pace with the nimble Americans.

least change coming in Japan's showcase sector—manufacturing.

Many of the explanations for Japan's malaise focus on structural issues, recognizing Schumpeter in spirit, if not by name. There is, for example, the "zombie hypothesis" that Japanese banks concealed bad credit issued to large money-losing firms, keeping them alive by discounting interest rates and constantly renewing loans. Throwing good money after bad led to a scarcity of investment funds for more productive enterprises, and the overall economy's productivity and growth rates sagged.

These views are on the right track. They recognize structural reform in the financial, industrial and government sectors as necessary for recovery. Their fault lies in being incomplete. A Schumpeterian approach offers the necessary breadth and depth for a proper diagnosis of Japan's ills.

Canada's Fraser Institute compiles broad data on nations' policies in terms of the freedom to compete and choose, with secure property rights and voluntary exchange. On a scale of zero to 10—worst to best—the Fraser index measures economic freedom in five major areas: size of government, legal structure and security of property rights, access to sound money, freedom to exchange with foreigners, and regulation of credit, labor and business. Data for 1995, the approximate midpoint of Japan's malaise, show the country with a mediocre score of 5 or below in seven specific areas—all indicative of policies impeding the economy's ability to revitalize itself. The United States, a country that showed a lot of economic zip in the 1990s, had significantly higher scores in each of these measures *(Chart 3)*.

Let's examine some specifics:

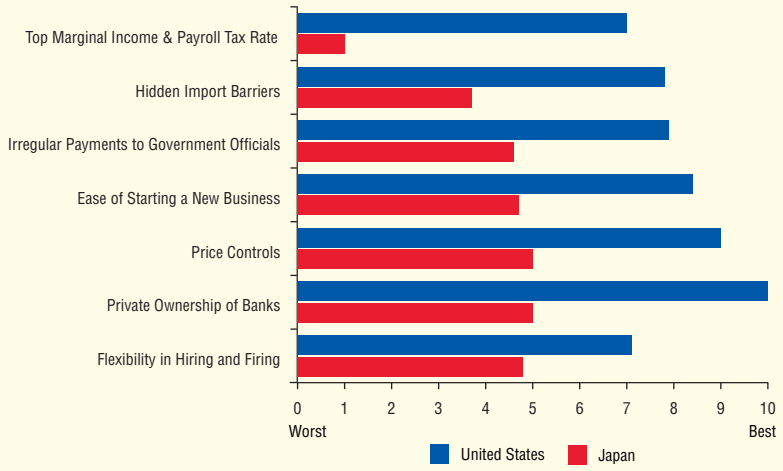
• Taxes were onerous. Japan's top marginal income tax rate kicked in at a very low income level compared with other nations. High taxes don't just discourage hard work, they also lower the return for risk taking and discourage innovation and entrepreneurship—the cornerstones of progress. High payroll taxes reduce workers' incentive to keep up with new technologies and enhance their skills.

• Japan maintained a large number of hidden barriers to imports. Numerous Lilliputian rules and regulations impose unnecessary restrictions on packaging, licensing, labeling, quality control, technical standards and so on. In stifling foreign competition, they allow domestic inefficiencies to linger.

• Irregular payments to government officials were another worrisome sign. Favoritism in regulatory decisions, subsidies to special interests, cronyism in hiring and firing—all such activities contribute to the nexus of politics and business that supports existing economic interests and makes it harder on newcomers.

• Japan erected hurdles to starting new businesses and discouraged price competition. Barriers to entry are a well-recognized and effective means to keep new competition at bay and

Chart 3
Economic Freedom in the U.S. and Japan, 1995
(Fraser Index Scores)



SOURCE: *Economic Freedom of the World: 2005 Annual Report*, by James Gwartney and Robert Lawson, Vancouver: The Fraser Institute, 2005.

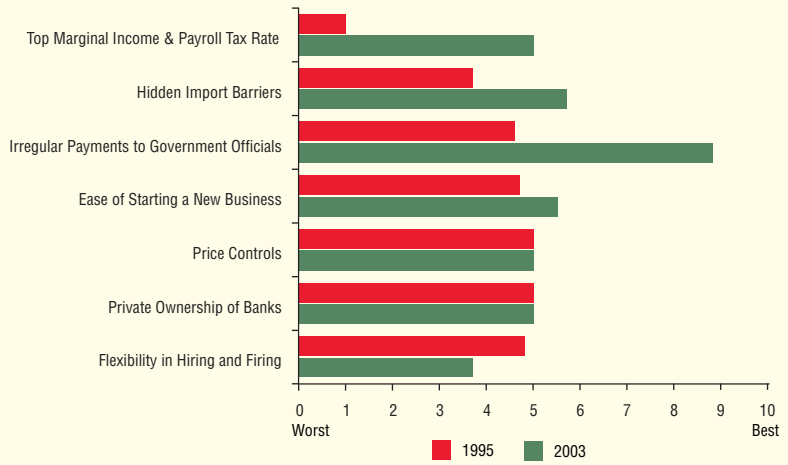
preserve markets for existing suppliers. Price controls inhibit the signaling mechanism that restructures the economy away from declining sectors toward growing ones, from inefficient businesses toward well-managed ones.

• Japan's banking system contributed to the inflexibility. More than 40 percent of companies' shares are held by bank-related institutions, and members of the *keiretsu* (business family) own 20 to 30 percent of the shares of their group's bank. As a result, banks lend mainly to entrenched companies with which they have a relationship rather than funding up-and-coming ventures. Institutions are overly concerned with collateral, and credit is allocated on the basis of export performance. This is not a financial system favorable to new or small companies.

These economic rigidities and others robbed Japan's economy of its ability to adapt by replacing old firms and jobs with new ones. Few of the impositions, of course, were new in the 1990s. Indeed, the policies that eventually slowed Japan were put in place during the years it prospered—many of them cited as key factors in the country's economic success. Why have they become problems in the past 15 years?

Japan's experience illustrates what makes economic meddling so tempting: Often, restrictive policies seem to work for a time, only to become a drag on the economy after they've been in place long enough to bind. With output and productivity so far behind the levels of world leaders, Japan could focus on developing specific industries, importing technologies and reaping economies of scale. These advantages played out, however, as Japan reached economic maturity and needed an environment designed more to lead than to follow. Japan then faced the whole new challenge of repositioning its economy, welcoming emerging industries and creating a new generation of jobs. When it needed to be more dynamic, Japan found its economy too high cost to compete with the Chinese and too inflexible to keep pace with the nimble Americans.

Chart 4
Economic Freedom in Japan, 1995 vs. 2003
(Fraser Index Scores)



SOURCE: *Economic Freedom of the World: 2005 Annual Report*, by James Gwartney and Robert Lawson, Vancouver: The Fraser Institute, 2005.

Steps Toward Economic Reform

Crisis often provides a catalyst for change. The Japanese, having seen their once-vaunted economic system struggle for a decade, have begun to accept the need for fundamental reform. Prime Minister Junichiro Koizumi led his party to electoral victory in October by advocating what at one time was unthinkable: privatization of the postal savings system that has invested in questionable public works projects. By keeping a big chunk of Japan's household wealth out of banks, postal savings stunted the growth of other, more effective financial institutions. The privatization won't be completed until 2017, but first-stage reforms already allow Japanese savers to buy mutual funds at post office windows.

Other areas also reflect Japan's increased willingness to reduce its economic system's rigidities. The latest scores from the Fraser Institute's survey show that Japan improved between 1995 and 2003 in four key areas—taxes, hidden import barriers, irregular payments to government officials and ease of starting a business *(Chart 4)*. Scores remain the same in two areas—price controls and private ownership of banks. Not all signs are positive: The Fraser barometer on flexibility in hiring and firing fell from 4.8 in 1995 to 3.7 in 2003, indicating new impositions on firms' ability to adjust their labor forces.

Job creation and destruction are normal—indeed, integral—parts of economic revitalization. Schumpeter recognized as much when he coined the term *technological unemployment* to echo creative destruction. Most unemployment is technological in nature, the result of new and better products or production methods. Just as important, most unemployment is temporary. Displaced workers find new jobs in expanding firms and industries. For the economy as a whole, flexibility in hiring and firing is

Adaptability is the key to success in a globalizing world economy.

essential to recycling labor from less valuable to more valuable uses. Protecting workers from competition and change can be just as damaging to an economy as protecting firms.

In a capitalist system, there should be no equating unemployment with failure, dishonor and shame. Yet, there are signs that just such an interpretation too often holds in Japan and presents an impediment to labor-market reform (see box titled "Suicide and Unemployment in Japan").

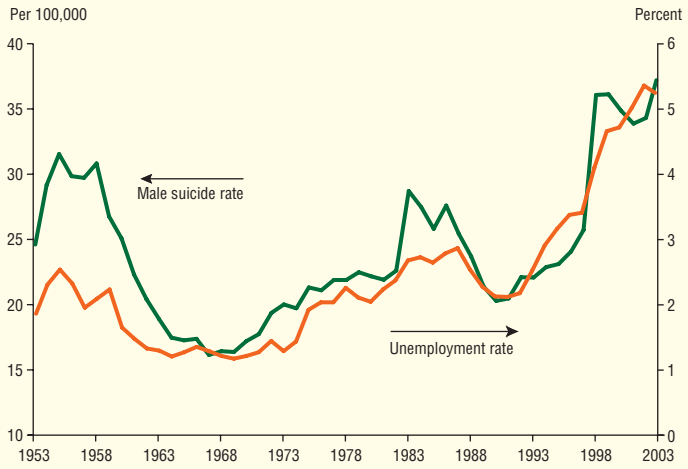
Although the Fraser data cast doubt on Japan's willingness to change its attitudes and practices on job losses, some encouraging signs have begun to appear. Over the past few years, Japan has seen a marked increase in the practice of employing part-time and contract workers in lieu of traditional "lifetime" workers. In effect, firms are bypassing the traditional system, with all its rigidities, by filling a greater portion of their workforces via less regulated channels. They get flexibility without having to wait for major reform. Canon, the giant electronics firm, now uses nonregular workers for 70 percent of its factory work, compared with 50 percent five years ago and 10 percent a decade ago.

Canon isn't alone. Overall, nearly a third of Japan's labor force is composed of contract or part-time workers, up from 20 percent just a decade ago. The increase in part-time and temporary workers is most prevalent among the young, but in every age cohort the proportion has increased *(Chart 5)*.

This trend is a hopeful sign for two reasons. First, it brings the labor market flexibility sorely needed for economic evolution. Second, it reflects an acceptance of the notion that jobs are not permanent.

In Schumpeter's constantly churning vision of capitalism, opening new markets is a key factor driving creative destruction. So trade and cross-border investment can play an important role in fomenting economic change. For Japan, as well as other countries, the rapid rise of China presents challenge and opportunity. Trade between the two countries has nearly doubled over the past four years. Japan imports mostly Chinese consumer goods, many made by subsidiaries of Japanese companies. China relies on Japan for capital goods—in particular, electrical, general and precision machinery, all relatively high-tech inputs into China's production process *(Chart 6)*.

Suicide and Unemployment in Japan



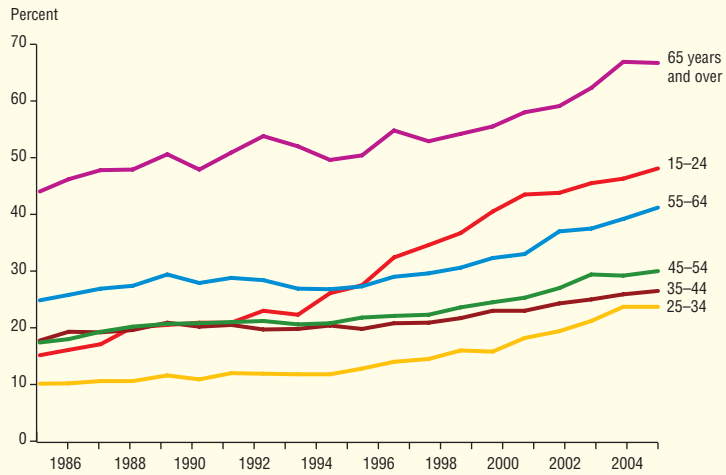
SOURCE: Japanese Ministry of Health, Labor and Welfare.

Restrictive labor practices often reflect a society's fear of the disruptions caused by job losses. Do Japan's fears go even deeper? An unusual link between male suicide rates and unemployment suggests that Japan exhibits a cultural psychology that makes job losses a particularly heavy burden.

From 1953 to 2003, each 1 percentage point increase in the cyclical component of the male unemployment rate led to a 5.39 percentage point increase in the cyclical component of the male suicide rate. This effect is 38 times larger for Japan than for the United States. The link holds for women in Japan, although it is much weaker, at 1.38 percentage point. There is no significant relationship between female suicide and unemployment rates in the United States.

The strong link between unemployment and suicide probably reflects two aspects of Japanese society. First, the Japanese are more likely to interpret losing a job as a personal failure, rather than the normal working of the economic system. Second, they may be more pessimistic about finding new employment in an economy that doesn't feature robust job creation.

Chart 5
Part-Time and Contract Workers in Japan

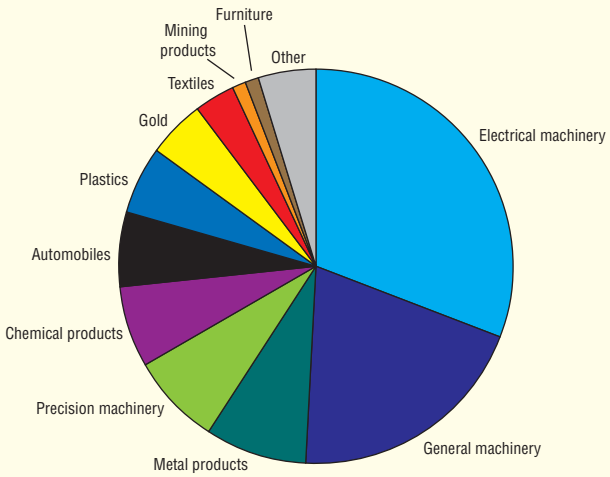


SOURCE: *Statistical Handbook of Japan 2005,* Japanese Ministry of Internal Affairs and Communications, Statistics Bureau and Statistical Training and Research Institute, Chapter 12, "Labor"; unpublished data.

The combination of Japanese technology and Chinese labor is helping Japan Inc. revamp its operations for global efficiency.

Japan ranks among the leaders in foreign direct investment in China. Such prominent Japanese companies as Toyota, Toshiba, Hitachi, Sony and Honda have spent billions of dollars to set up low-cost production facilities in China—in effect, finding a cheap-labor alternative to their own rigid labor market *(Chart 7).* The combination of Japanese technology and Chinese labor is not only helping keep Japan Inc. competitive but also forcing changes at home as companies revamp their operations for global efficiency.

Chart 6
Japan's Exports to China, 2003



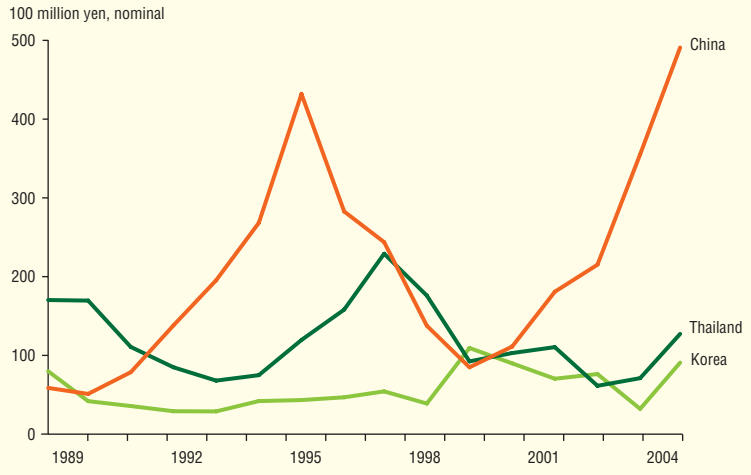
SOURCE: Japanese Ministry of Finance.

Real Recovery, or Another False Dawn?

A number of upbeat statistics and reports on Japan's economy have begun to appear, suggesting the country may finally be getting through its soft patch. GDP rose 2.9 percent in the most recent four quarters, adding to a 2.4 percent gain the previous 12 months. In the past two years, the unemployment rate fell to 4.5 percent from 5.1 percent. Industrial production has been rising, although not at the pace of the miracle days. And the Nikkei increased 40 percent in 2005.

Chart 7

Japan's Foreign Direct Investment in Asia



SOURCE: Japanese Ministry of Finance.

Has a real recovery at long last begun? There is no guarantee. The country's economic measures have turned upward before, only to lose steam. As encouraging as the recent performance has been, Japan's economic revival will require further progress in sweeping away impediments to innovation, productivity and growth. Japan has shown a new willingness to reform, but the job is far from finished. Like Germany and other nations, Japan needs to embrace creative destruction, not avoid it.

Adaptability is the key to success in a globalizing world economy. When business and labor use government to reject change, protect firms and shield workers, the economy will eventually become less competitive and less productive. The best long-run policy involves avoiding protectionism and letting the economy evolve—so it can stay competitive and vibrant. Because labor is an economy's most valuable resource, it is particularly important that Japan's workers see opportunity, not loss, in the nation's transition from lifetime employment to upward mobility.

Cox is senior vice president and chief economist and Koo is an economist at the Federal Reserve Bank of Dallas.

Notes

The authors thank Julia Carter for research assistance.

[1] For data on U.S. residential land values, see "The Price and Quantity of Residential Land in the United States," by Morris A. Davis and Jonathan Heathcote, Federal Reserve Board of Governors Finance and Economics Discussion Series, 2004-37, July 2004. Data on Japanese land values are available from the Japan Real Estate Institute, www.reinet.or.jp.

[2] For a discussion of this view, see *Balance Sheet Recession: Japan's Struggle with Uncharted Economics and Its Global Implications*, by Richard C. Koo, Singapore: John Wiley & Sons, 2003.

[3] For a discussion of this view, see "Preventing Deflation: Lessons from Japan's Experience in the 1990s," by Alan Ahearne, Joseph Gagnon, Jane Haltmaier and Steve Kamin, Federal Reserve Board of Governors International Finance Discussion Paper 2002-729, June 2002; "Monetary Policy and Asset Price Volatility," by Ben Bernanke and Mark Gertler, Federal Reserve Bank of Kansas City *Economic Review*, Fourth Quarter 1999, pp. 17–51; and *The Lost Decade for the Japanese Economy: Policy, Failures and Strategies for Recovery*, by Harada Yugata, Tokyo: Nihon Keizai Shimbun, 1999.

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