Japan: "Free, Fair, Global?"

Teaching Note

This case examines the economic performance of Japan between 1971 and the spring of 1998 – especially the stagnation that has prevailed since 1991. The case dwells on institutional rigidities that have developed in the Japanese polity and Prime Minister Ryutaro Hashimoto's strategy for restoring Japan to a positive growth path.

The principal teaching objective of the case is to examine the causes of Japan's stagnation, especially the apparent liquidity trap in which Japan is stuck. To explore the reasons for this trap, the case describes at length the institutional rigidities that preoccupy Japanese businessmen, trying to understand how they've effected both the supply and the demand sides of the economy. How could the structure of the Asian miracle have reversed its effectiveness? Do the institutional strengths that produced the miracle now clash with conditions of globalization, or have they changed, becoming ineffective?

Teaching questions

1. How did Japan perform until 1991? How do you explain this performance?

2. Why has Japan stagnated since 1991? Why does neither fiscal nor monetary policy seem to work? What is the role of the very institutions that seem to have facilitated the miracle?

3. Is Hashimoto's plan likely to help?

This note was prepared by Richard H.K. Vietor for the sole purpose of aiding classroom instructors in the use of Japan: "Free, Fair, Global?", HBS No. 798-083. It provides analysis and questions that are intended to present alternative approaches to deepening students' comprehension of business issues and energizing classroom discussion.

4. How long can Japan's current account remain in surplus? Is this a good time to buy Yen? What effects will the Asian crisis have on Japan?

5. For non-Japanese firms, is this a good time to invest in Japan?

Analysis of the Miracle, 1971-1991

The first two pages of the case (after the introduction) describe Japan's phenomenal growth during the two decades after 1971. It elaborates the series of shocks (Nixon Shock, Oil I, Oil II, Endaka) to Japan's economy, and the rise of the Yen through this period. Most of the exhibits date from either 1971 or the early 1980s.

From these, one can extract a picture of Japan's exceptional performance. **Exhibit 1** show average growth of real GDP at 4.3% per year for the twenty year period! It also shows that in US$$, Japan's GDP per capita rose from $5,000 in 1971 to $39,190 in 1995 ($13,000 greater than the USA itself). The structure of the GDP reflected Asian-style economic systems: low consumption (53%-59%), low government (9.7%), and high investment (35.8%- 30.7%). It is important to note that this investment level is huge; it is not 32% of a developing economy, but 32% of the world's second richest nation! It should especially be noted that during Endaka (era of high Yen, 85-91), investment actually increase from a low of 27% back to 32%. In otherwords, when the Japanese were pressed by Yen appreciation, they hunkered down and invested more – rebuilding plants and substantially increasing their productivity growth in order to remain competitive! Finally, one might note that exports as a percent of GDP never exceeded 15% in real terms, and at the end of the period are less than 10%. Japan, in otherwords, is a big country (with more than 120 million people), and its growth was export-oriented, but not export-led (e.g, high export/GDP ratio as in Europe).

Exhibit 4 is the balance of payments. It shows the incredible trade surpluses over the period, and a current account surplus in every year except the second-oil shock (1979-80). One can see the sharp jump in the trade surplus between 1982-83, as the US $ appreciates, and the decline from 1987-90, as the Yen appreciates. Then one sees the sharp decline in imports during the first Japanese recession (1991-93), and again for the second (1997). Especially after 1995, with the very strong Yen, one sees the drop in exports, trade balance, and current account – although by 1997, the latter two are strengthening again. On the capital account, one sees extraordinary foreign direct investment, equal to $32.6 billion up to 1985, and $302 billion afterwards. **Exhibit 13** shows the immensity of cumulative FDI, and the paucity of inward FDI. One also sees from **Exhibit 4** portfolio investment of $226 billion after 1995. To no surprise, back on the current account there emerges a huge net income flow – amounting to $386 after 1985. Japan is making so much on FDI, portfolio, and other long-term investments that it can pay for all FDI without using its trade surplus!!

The budget, in **Exhibit 2,** shows very slight deficits prior to 1978 – but then larger ones – reaching 5.9% of GDP in 1980. By 1996, these deficits are again huge (4.5% of GDP), but are apparently failing to stimulate the economy. Debt (% GDP), meanwhile, rises steadily until 1986, then shrinks during Endaka (as GDP outgrows deficits/GDP), but then begins to rise sharply, to 54% of GDP by 1998. **Exhibit 3** shows the structure of government spending heavily weighted towards public works and other (industrial policies) prior to the mid-80s, with social security beginning to grow fast in the 1990s.

Exhibit 5 shows the immense growth of Japanese savings, and the successful control of inflation after 1974-75 (oil shock) and 1980 (oil shock). [Japan's high savings is also shown in **Exhibit 17**). Especially low inflation rates occur early in Endaka (as import prices drop dramatically) and again in 1994-96 – again, due to low import prices and domestic deflation as well. You can see that M2 growth after 1991 scarcely covers the sum of real GDP growth plus inflation.

Exhibit 6 shows the incredibly run-up of the Nikkei index, from under 8000 in 1982, to 38,000 by 1990. This, together with inflated land prices, represents the boom in asset prices that developed as Japan got rich during the 1980s. Interest rates, meanwhile, dropped steadily until 1989, when the central bank, deciding that asset and price inflation were getting severe, intervened. **Exhibit 7** also shows the incredibly low unemployment rate, especially during Endaka, and the sharply-rising value of the Yen.

Exhibit 15 is especially interesting. It shows the Yen exchange rate against the dollar in purchasing power parity terms for consumer prices, producer prices, and export prices. What is interesting is how high domestic consumer prices are as compared with export prices.

So why did Japan perform so well during this period? Several answers arise from a combination of this data and the strategy and structure introduced earlier in Japan D-1. The growth appears to be investment-driven and export-led. Consumption and government remained under control, even as Japan became rich. As exchange rates appreciated, Japan benefited from cheap imports. It maintained its trade surpluses with competitive products, squeezing costs by holding down inflation, holding down returns on equity, and by massive re-investment. It benefited, of course, from lower oil prices after 1985. Although government deficits grew large in early 1980s, high growth during Endaka combined with moderation of government to produce effectively balanced budgets by the early 1990s. Savings remained high, and Japan used its current account surpluses to invest widely abroad – both equity and debt. Finally, it looks like the structure of the economy scarcely changed during this period. It remained an investment-driven, export-led economy – with neither consumption nor government spending ever rising to western levels.

One might even conclude from this data (especially **Exhibit 15**) that Japan essentially became two economies; one export-driven, efficient, and low cost; the other, high cost, high price, inefficient and protected, catering to domestic economic needs. By successfully keeping these two economies separate, Japan failed to adjust its domestic economy to the globalization that occurred during the 1970s and 1980s. Thus, by the early 1990s, when its asset bubble broke, Japan became exposed to an internationally competitive environment, with a domestic economy that for more than twenty years has been protected, and failed to adjust.

Causes of stagnation

When inflation spiked in 1989, the Bank of Japan moved to cool the economy down by raising interest rates. From 2.5% (0% real rate), the discount rate (**Exhibit 7**) was raised to 6% (an increase of 140%). Asset prices fell (**Exhibit 6** shows Nikkei falling by more than half, to 16,000 by 1992), and the economy slowed to less than 1.0% by the end of 1992. Japan entered recession.

What is extraordinary, of course, is that Japan did not recover. It stayed in stagnant during 1993 and 1994, and only by massive fiscal stimulus did it manage growth of 1.4% in 1995. Recession appeared over, however, in 1996 as growth surged to 3.6%, but as the government moved to restore fiscal balance (by instituting budget cuts and raising the consumption tax from 3% to 5%), it precipitated recession again late in 1997 and 1998. Growth during the first quarter of 1998 was negative 3.7%, and unemployment (**Exhibit 7**) had risen to 3.5%. The text mentions that it was 3.9% by April 1998.

Why had Japan's economy stagnated for nearly seven years? The causes have been increasingly debated, and everyone has a theory. *The Economist* sees both supply-side and demand-side failures.[1] Stanley Fischer of the IMF focuses on collapsed aggregate demand.[2] Clyde Prestowitz, president of the Economic Strategy Institute, blames excessive regulation – especially failed controls in the finance sector.[3] Charles Wolf Jr., of Rand, blames Japan's non-tariff barriers and excessive taxes.[4] Wayne Angell, chief economist at Bear Sterns, cites oversavings as

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[1] "Japan's Economic Plight," *The Economist*, June 20, 1998, pp. 21-23.

[2] Stanley Fischer, "The Asian Crisis, the IMF, and the Japanese Economy," Tokyo, Japan, April 8, 1998.

[3] Clyde Prestowitz, " It's Now Up to Outsiders to Develop an Action Plan for Tokyo," *New York Times*, April 8, 1998.

[4] Charles Wolf Jr., "Japan Can't Export its Way to Prosperity," *Wall Street Journal*, May 20, 1998.

the cause.[5] And Paul Krugman, a distinguished economist at MIT, blames the problem on a "liquidity trap."[6]

Let me start with the demand-side of the economy. It is very weak. **Exhibit 1** shows that after rising to a highpoint of 60.2% in 1983, consumption gradually declined as a share of the economy to a low of 57.1% in 1991. Then, after fiscal stimulus pushed it to 60.2% by 1995, it again declined. Personal savings, moreover, has been stable at about 13-14 percent thoughout the 1990s. If potential output has been growing at 2% annually since 1991 (which, given the immense level of investment is likely), and actual GDP has grown at 1.3%, there must be considerable spare capacity – a large output gap. After the consumption tax was raised to 5%, consumption fell dramatically. The stagnation of the economy, moreover, has alarmed many Japanese – some even feeling that their jobs are threatened. This has induced more savings, and even less consumption. Thus, inadequate demand is part of the problem. Thus, there is not only no demand for spending, but no demand for investment – at least, for domestic businesses.

On the supply-side, there are also considerable problems. Clearly, failures in financial markets have severely dampened the willingness of banks to lend. And given that real estate prices continue to fall, and ROE is pitifully low, there is little demand for investment funds – even with interest rates at six-tenths of one percent (**Exhibit 6**). Japan, moreover, remains a heavily-regulated economy. Although one of Hashimoto's six initiatives entails deregulation, very little has happened thus far. The retail and wholesale sectors, multi-tiered and hugely inefficient, are heavily regulated (and politicized). And despite some privatization (in telecommunications), the energy sectors, telecommunications, transportation, and banking are all still regulated. All of this adds costs and prevents rationalization (of the kind that's been happening in the USA for at least 18 years) from occurring. Moreover, the Prestowitz piece indicates, these controls (or their effects) translate into huge non-tariff barriers, which is why Japan continues to import so little, and continues to attract so little FDI.

Japan's supply-side is ensnarled in institutional rigidities that have prevented adjustments to a more efficient, global economy for at least two decades. Although those institutional arrangements once worked stunningly, they now hamper competitive adjustment. Among these are (1) a productive, yet rigid, work force; (2) a financial system that, after a decade of wild growth and inept regulation, is now failing; (3) a strong bureaucracy that regulates the domestic market rigidly, but less effectively, than it once did, (4) a system of corporate governance that fosters low export prices and seeks market share, rather than return on equity; and (5) social

[5] Wayne Angell, "How to Save Japan From Oversaving," *Wall Street Journal*, June 22, 1998.

[6] Paul Krugman, "Japan's Trap," May 1998, http://web.mit.edu/krugman/www/japtrap.html.

rigidities – unproductive women, non-innovative education, and a rapidly aging work force – that neither strengthen demand nor supply. Let's consider these one by one.

Labor markets, in terms of permanent employment and seniority wages, are rigid. Among the large firms (involved in exports), it is impossible to reduce the number of workers to streamline and grow more efficient. Now, with substantial excess capacity, these firms can not layoff workers. Moreover, to mitigate social-security problems, the retirement age is being raised. At the same time, the senior wage system guarantees these older workers higher and higher wages – thus raising wage costs of firms that need to be competitive.

Japan's financial system is in crisis. Developed in the 50s and 60s as a tightly controlled system of debt-financing, it has never really matured. Even after the stock market developed in the early 1980s, bank debt (based on deposited savings) remained by far the principal means of financing. **Exhibit 12a** and **Exhibit 11** show the importance of keiretsu groups which continue to shield almost half of all equity (certainly the controlling interest) from market pressures. Thus, firms are free to earn low returns. **Exhibit 12b** shows earnings averaging 3% ROE during the 1990s.

Banks, which are very large (**Exhibit 8)**, lent heavily during the late 1980s – to real estate developers, to investors, and to southeast Asian banks and foreign-investing Japanese businesses. When asset prices collapsed between 1989-1992, these banks ended up holding more and more non-performing debt. In 1997, when southeast Asia collapsed, their non-performing debt worsened, and continues to worsen as the Nikkei hovers in the fifteen thousands. **Exhibit 9** summarizes the banks loan position in early 1998 – non-performing loans (categories 2-4) add to $590 billion, even after several years of substantial write-offs. And this is not the end of it, because Japan's reporting standards, even after the recent announcements of debt problems, remain considerably more liberal than those of western countries.

Bureaucracies remain exceedingly powerful in Japan; the legislature, by contrast, is fragmented and relatively weak. It is true that MITI, one of the very strongest bureaucracies credited with much of the miracle, has lost a good bit of its power – control of foreign direct investment, of technology, and of trade. But the Ministry of Finance (MOF) has remained at the center of governmental decision-making. It not only controlled the banking and securities sectors (the Bank of Japan), but both sides of fiscal policy – taxation and spending. The MOF must, therefore, bear much of the blame for Japan's banking crisis and its economic crisis.

Corporate governance in Japan remains as it was 30 years ago. Although firms have become very large and less levered, there is still no outside pressure on their performance. Equity remains locked up in group structures, and earns very little. Boards of directors are controlled entirely by insiders. Close ties with bureaucracies persist, through the system of *amakudari*, through the decision-making system of government-business councils, and through an extraordinary old-boy network.

Ancillary social issues (from an American perspective) are worth noting. Women still have no managerial position or power. Education is still based on rote learning – leaving innovation to westerners. And the pension system is soon to be overwhelmed by the graying of Japan's population (**Exhibit 14** and **16**). This will shortly put immense pressure on taxation and fiscal budgets.

Let me turn to the macroeconomic issues. Japan in the 1990s seems to have exhausted monetary-policy options and nearly exhausted its fiscal-policy options. As such, it appears to be in the proverbial "liquidity trap." An economy is in a liquidity trap "if aggregate demand consistently falls short of productive capacity despite essentially zero short-term nominal interest rates."[7] Well, the Bank of Japan's discount rate was lowered steadily from 6% in 1991 to .5% in 1995, where it has been every since. Short-term market rates are .6%, and the overnight money –market rate, .37%. So nominal rates are virtually zero. Real rates, at best, are only slightly negative. Still, there is no demand for borrowing. Krugman explains that a liquidity trap will arise only if future productive capacity is actually lower than current capacity. Is this possible? A declining birth rate (with no immigration) means a shrinking labor force. Thus, it is possible that without much productivity growth, per capita productive capacity might actually be lower in the future. Problems in financial markets constrain investment. And even with the Big Bang in place after April 1, 1998, Japanese savers lack experience (e.g., familiar channels) or even risk-taking, to invest abroad. So savings continue to pile up; a liquidity trap.

In these circumstances, there are three possible solutions: (1) structural reform, (2) fiscal policy, and (3) monetary policy (of a peculiar sort). Let's reserve structural reform for the next section of this note, on Hashimoto's plan. Fiscal policy is the obvious alternative to monetary policy. The Japanese tried this in 1994-95, pumping up deficit spending on public works. It had some positive effect, but then dissipated after 1996 when Hashimoto raised taxes and began trying to reduce deficits. Deficits are quite large in 1997-98, but the economy is plunging deeper into recession. Krugman cites "Ricardian equivalence" as a reason why tax cuts won't work. That is, if government cuts taxes, people will simply increase savings in anticipation of future tax increases to make up revenue losses. There may be some first round benefits to a spending increase, but again, Krugman sites Ricardian equivalence" negating any lasting gains.[8] So that leaves monetary policy – but only one that might effectively promise to be *irresponsible* – "to make a persuasive case that it will

[7] ibid., 8.
[8] Ibid., 10.

permit inflation to occur, thereby producing the negative real interest rates the economy needs."[9]

Hashimoto's Plan

Shortly after taking office, Ryutaro Hashimoto introduced a major set of reform proposals under the rubric "Free, Fair, Global." There were six parts to this proposal: (1) administrative structure, (2) economic structure (e.g., deregulation), (3) education structure, (4) financial structure, (5) fiscal structure, and (6) social security structure. These proposals required various pieces of legislation and administrative action which would unfold, if Hashimoto stayed in power, over the period 1997-2001. The proposals are described in the text, and don't need repetition here. However, there are two questions that should be asked of students: (1) are these (politically) feasible, and (2) will they work (e.g., get Japan growing again)?

First, the feasibility. This depended in large measure on Hashimoto's own political career. Had he stayed in power and retained control over the LDP, then they could have been feasible. Certainly, restructuring government bureaucracies is feasible. So is deregulation, to the extent that the reform actually proposes it. The financial reforms are possible, but continuing problems in Asia and continued deflation at home with corruption in the Ministry of Finance and Bank of Japan make these more difficult to do. The fiscal reform, after the spring of 1998, becomes impossible. That is, Hashimoto decided (under pressure from the USA among others) that Japan needed stimulus, not contraction. So the deficits will actually get larger for the next couple of years, not smaller. Education reform does not look likely to have much of an impact, and how the social security system is to be changed will not be decided for another year or so. But Hasimoto's LDP lost the mid-term election in July, and Hasimot resigned. For now, the strategy is unclear!

Second, would it work. Even if they could do all that was called for, I don't think this package would work, completely. Take deregulation, for example. They were proposing only very minor deregulatory efforts. Allow a few more airline competitors a few more gates; allow larger retail establishments (but still regulated). Let some more competition happen in telecommunications, but leave NTT as the dominant player. Note that MITI has listed 15 growth sectors, but does not really have the wherewithal to do much to make them into national champions. Note that nothing was being done to really encourage FDI, other than deflating assets. Or take the educational reforms. These would take a very long time to implement, and would not (in the next few years) stimulate Japanese innovation significantly. Or the social security reforms – there were five choices, none of which people will want.

[9] Ibid., 11.

Sooner or later, the Diet is going to have to choose some combination of reduced benefits and larger contributions.

Asian Crisis, FDI, CA Surplus, and Yen/Dollar Rate

The fourth area for discussion in this case really builds on the analysis already done, and then broadens out to other issues developed in the course.

First is the effect of the Asian Crisis on Japan's economic performance and the viability of Hashimoto's plan. The Crisis clearly hurts Japanese banks that are heavily involved in southeast Asia. The worse the crisis gets, and the longer it lasts, the bigger the problems are for Japanese banks. One should note that much Japanese lending was to Japanese companies invested in southeast Asia. Thus, while it is secure in a sovereign sense, it suffers to the extent that those assets are suffering. Moreover, as the Yen depreciates, foreign debtors need even more dollars to cover their dollar-denominated obligations to Japan. Moreover, Japan sent a significant portion of its exports to southeast Asia, either for end-consumption or as an input to manufacturing operations for re-export. Demand in those domestic economies has withered, and demand in Japan is not much better. The absence of the largest regional economy as a healthy market puts more pressure on China to devalue.

Is this a good time for western businesses to invest in Japan? Well, yes and no. Yes to the extent that Japan remains the region's dominant economy and to the extent that Japanese assets have gotten much cheaper for westerners to buy. There are significant distress opportunities, at least in business related to financial services. But no, in the sense that it will remain difficult – in fact, it should become more difficult – to make money in Japan. If Japan rationalizes, prices and margins should remain relatively thin, if one is doing business primarily in the domestic market.

Can Japan continue to run a current account deficit indefinitely? The answer is no, but it may be able to run one for several more years! Sooner or later, however, the USA is going to bring political pressure on Japan to reduce its surplus – either by importing significantly more, or by being allowed to export less. The USA will not allow its assets to be purchased, indefinitely. And even sooner, the Yen should appreciate – significantly – but not until Japan has made many of the above-mentioned reforms. I think that the timing problems here might be very difficult. That is, the Yen could stay low too long, and the current account could stay in surplus too long, for the USA to tolerate.

Teaching Plan

My teaching plan is straight-forward, based on this analysis. After introductory remarks about the model of Asian growth and the incredible success of

Japan's miracle – mentioning the GDP/capita of $39,000 in 1989, I will turn to doom and gloom – seven years of stagnation, ending most recently in recession, with unemployment rising to meet US unemployment for the first time in more than half a century. Then I will lay out a four-part plan, to discuss (1) causes of miracle growth 71-91, (2) reasons for stagnation after 1991, (3) an evaluation of Hashimoto's Plan, and (4) a look forward at Asian Crisis, FDI, CA, and Yen.

Q. Why did Japan grow at 4.3% annually for 20 years after the miracle?

Q. Why has it stagnated in the 1990s?

Q. What are the institutional problems?

Q. Why isn't monetary policy working?

Q. Why isn't fiscal policy working?

Perf 71-91	Causes?	Causes of Stagnation?	Supply/Institutional Rigid.
		Monetary?	
		Fiscal?	
		Demand-side?	

Q. What do you think of Hashimoto's plan?

Will help	Plan	Won't help	Implementation difficulties
	Administrative		
	Deregulation		
	Financial system		
	Fiscal policy		
	Social security		
	Education		

Q. What's your forcast for Japan's trajectory in the next five years?
as to Asia Crisis, FDI, CA, Yen rate?

Asia crisis?	FDI in Japan?	CA Surplus?	Y/$

Conclusion: If one gets through this entire plan, one does not really have to draw a conclusion. It would, I think, be better to ask students what they conclude – about the Asian Miracle and globalization.