CHAPTER 1

INTRODUCTION

After demonstrating seemingly unsurpassable competitiveness for several decades, the Japanese economy experienced a major reversion from prosperity to stagnation in the 1990s. Observers confront a daunting question: How do we explain this reversion?

Some comparative statistics will illustrate the extent of the crisis. In the period following World War II, Japanese economic growth was astounding, occurring at an average annual rate of 9.3 percent in 1956–1973 and 4.1 percent in 1975–1991. From 1946 to 1976, the Japanese economy increased 55-fold (Johnson 1982, 6). Between 1955 and 1973, Japan quadrupled its gross domestic product (GDP) per worker from $3,500 to $13,500. This sustained record of growth is reflected in the conclusion drawn by Richard Katz (1998, 55): “No other major country, before or since, has managed this all-important development task in such a short time.”

In the last decade of the twentieth century, however, the bubble of the Japanese economy burst. The depth of the crisis was as astonishing as the extent of the preceding success. In the 1990s, the Japanese economy grew at a mere 1 percent per year on average. In 1997 and 1998, it even experienced negative growth. According to one estimate, Japan lost 800 trillion yen in the stock and real estate markets between 1989 and 1992; this loss was equivalent to 11.3 percent of the country’s national wealth. Both markets continued to slump after 1992, sinking to (or below) levels perhaps comparable to those in World War II, during which Japan lost 14 percent of its national wealth (Kikkawa 1998, 6–7).[1,2]

1 In the text, Japanese names appear according to Japanese custom, with the surname preceding the personal name. In the references, Japanese authors use surname-first order for Japanese-language publications and surname-last order for English publications.

2 This comparison may be an exaggeration. According to another source, Japan lost more than 25 percent, instead of merely 14 percent, of its national wealth during World War II. See Arisawa Hiromi (1976, 241).

Although the rise and fall of an economy is nothing unusual in history, the magnitude of the Japanese economy's swing within such a short period of time, in the absence of major wars, is unprecedented. The fall of the Japanese economy from glory to chaos presents a serious challenge for students of Japanese capitalism. Before the crisis of the 1990s, observers were engaged in constant debates attempting to explain the economy's high growth rate. With the advent of the recent crisis, a new explanation is needed as to why this highly successful model of capitalism suddenly reversed its course.[3] And as if each of these two spectacular processes weren't enough, students of Japanese political economy confront the most challenging task of all: to explain Japan's past success and its recent failure and to discover a coherent link between them.

THREE THEORIES

Several studies in the English-language literature have tried to explain the reversion of the Japanese economy by comparing its past prosperity and its present stagnation.

Robert Brenner emphasizes "the capital accumulation and profitability of the system as a whole" (1998, 23). Through an analysis of the American, Japanese, and German economies, Brenner provides a structural account of what he calls the long downturn of not only these three economies but also the global capitalist system as a whole in the second half of the twentieth century. Brenner argues that capitalist production is unplanned, uncoordinated, and competitive. Furthermore, competition in manufacturing involves large, fixed-capital investments in facilities and equipment. These facilities, however, tend to become outdated. In the 1950s and 1960s, sustained by a set of institutions that enabled the state, the banks, and the manufacturing industry to coordinate with each other, Japan and Germany enjoyed the advantages of unencumbered modernization through fixed-capital investment. This strong coordination not only protected Japan's domestic markets but also channeled its investments into new technologies. Then, when Japanese and German products penetrated the American market on a massive scale, rival fixed-capital physical plants were locked in confrontation, with no easy escape

3 Many studies have offered explanations of the recent crisis of the Japanese economy. Some studies focus on international factors. They argue that its causes include Reaganomics, the liberalization of finance, the coordination of multinational monetary policy, and rules promulgated by the Bank of International Settlements (Johnson 1998; Kikkawa 1998; Konishi 1999; McKinnon and Ohno 1997; Krugman 1999a, 1999b; Shibata 1996; Wade 1999; Yamada Shinichi 1996). In contrast, others have emphasized domestic factors. They have traced the origin of the crisis to either individual institutions, such as the Ministry of Finance and the Bank of Japan, or individual policies such as fiscal policy or window guidance (Asher 1996; Grimes 1995; Murphy 1996; Posen 1998; Werner 1999). For a discussion of window guidance, see also Chapter 2 of this volume.

to alternative lines of production. As a result, profits fell dramatically and in tandem across the entire advanced capitalist world. Even after two decades, they had still not recovered. As lower-cost producers continued to enter global competition, the rate of return on the older capitalist enterprises in advanced industrialized countries was further depressed. As a result, there was intensified, horizontal intercapitalist competition for overbuilt production capacity, and this competition in turn led to the fall of profitability at the aggregate level. The result was the long downturn of capitalism (Brenner 1998).

Richard Katz (1998) explains the reversion of the Japanese economy using the theory of development stages. He holds that the "catch-up" effect may explain 70 percent to 80 percent of Japanese growth and that the role played by state-mandated industrial and trade policies was simply to accelerate a normal catch-up process. In the 1950s and 1960s, many industries in the Japanese economy were in their infancy. The state's protection of these industries and its promotion of exports helped to sustain a set of catch-up structural processes: the economies of scale increased, the whole economy was shifting toward higher-productivity industries, the country imported technologies aggressively, and productivity increased in the agricultural sector. Meanwhile, the promotion of exports through government subsidies, along with the protection of domestic markets, sustained industrial growth through the rapid development of manufacturing industries. As the Japanese economy matured in the early 1970s, however, exports were no longer able to keep the economy growing. Meanwhile, the system began to resist the transformation of economic structures. Increasingly, state policy was aimed at preserving existing industries in an effort to protect resources unwisely invested in capital-intensive sectors and thereby prevent unemployment and maintain wage equality. As market-conforming industrial policy was replaced by market-defying industrial policy, the economy was "cartelized" and the dynamics for further growth were dampened.

T. J. Pempel (1998) offers a broad political explanation based on what he calls "regime shift." A regime, according to Pempel, consists of socioeconomic alliances, political economic institutions, and a public policy profile. Pempel attributes the primary sources of change to three important factors: socioeconomic alliances, the pattern of electoral politics, and the changes in international environments beginning in the early 1970s. During Japan's high growth period, conservatives dominated the electoral process. Public policies were adopted that strengthened the regime's socioeconomic base and increased overall public support. The regime also discredited the conservatives' political opponents, enhanced the conservatives' ability to control political offices, and minimized the need for compromise. However, as the economic structure shifted from agriculture to manufacturing industries, family businesses were increasingly replaced by corporations, and the tight labor market enhanced the bargaining power of labor unions. At the same time, the electoral pattern switched from two dominant political parties to multiple political parties. That began to threaten the conservatives' electoral hegemony. As a result of these changes, state economic policy-making became politicized, management had to compromise with labor unions, the government had to engage in deficit spending to enhance social infrastructure, and Japanese companies ceased being "embedded mercantilists" and became "international investors." All these factors eventually led to the Liberal Democratic Party's loss in the 1993 election.

These studies offer new insights that assist our understanding of Japanese political economy. First, they join a stream of recent social science studies that focus on the national economic system as the unit of analysis in the studies of comparative political economy.[4] As the distinctive patterns of national responses by the major industrialized countries to the First and Second Oil Shocks gave birth to the field of international and comparative political economy in the late 1970s, the ongoing debate on globalization has focused new attention on the national models of capitalist economies. This approach emphasizes "the systematic analysis of advanced capitalist economies," and it defines the institutional framework primarily at the national level, casting light on "how differences across economies in the configurations of these institutions might explain differences in micro behavior" (Soskice 1999, 101–102). This model is concerned not only with "identifying the various institutional mechanisms by which economic activity is coordinated" but also with "understanding the circumstances under which these various mechanisms are chosen, and with comprehending the logic inherent in different coordinating mechanisms" (Hollingsworth and Boyer 1997b, 1).

Second, these recent studies treat the early 1970s as the turning point at which a highly successful model of economic growth began to reverse its course. This is a major revision of the conventional wisdom of the past two decades, which interprets Japan's adaptation to the two oil shocks in the 1970s as highly successful, especially compared with that of other advanced industrialized countries. These studies show that although the macroeconomic performance of the Japanese economy demonstrated no sign of approaching a major crisis until the early 1990s, an ex post analysis indicates

4 Several recent edited volumes represent this new trend. See Berger and Dore (1997), Kitschelt et al. (1999), and Hollingsworth and Boyer (1997a). In Japanese studies, the tradition of taking the Japanese economic system as the unit of analysis with clear comparative implications is reflected in the works of Johnson (1982), Dore (1973, 1987), Samuels (1987), and Vogel (1979). For recent studies on Japan that have attempted to adopt the national economic system as the unit of analysis, see Aoki and Okuno (1997 [1996]), Gao (1997), Noguchi (1995), Okazaki and Okuno (1993); Pempel (1998), and Vogel (1996).

that serious internal problems had begun to grow, masked by the rapid expansion of Japanese economic power in the international markets in the 1970s and 1980s. In global capitalist production, the success of Japan and Germany in exporting their products to the international markets not only went hand in hand with the failing competitiveness of the United States in 1971–1989 but also contributed to overproduction and to the decline of profitability of global capitalism as a whole. That triggered a long downturn of capitalism in all advanced industrialized countries (Brenner 1998). From the early 1970s, the Japanese economy was losing its momentum in catch-up. As a result, Japan's early practice of protecting domestic markets through heavy government regulation and cartels caused a serious problem of inefficiency (Katz 1998). Reflecting this structural change in the economy, both socioeconomic alliances and electoral patterns changed profoundly, leading to a politicized process of economic policy-making (Pempel 1998).

POINT OF DEPARTURE

My point of departure from these studies lies in the nature of the changes after the early 1970s that caused the reversion of the Japanese economy.[5] Methodologically, I contend that the nature of such changes can be better understood by comparing the state of the Japanese economy during the period of high growth with that during the 1980s. The reversion of the Japanese economy did not appear in a straightforward fashion of stagnation beginning in the early 1970s and continuing along a linear direction. Rather, before the crisis of the 1990s, the Japanese economy witnessed a sudden spurt of energy in an extreme form – the astonishing economic prosperity known today as the bubble. Any explanation of the reversion that fails to make the bubble of the 1980s the central point of analysis will miss an important episode and its accompanying theoretical significance. In the English-language literature, the 1980s are marked as a decade in which studies on Japanese political economy were dominated by issues related to trade and industrial policy (but see Sassen 1991); these studies focused on the strength of the Japanese economic system in production. In Japanese economic history, however, the 1980s was also highlighted by financial and monetary issues. It was during the 1980s that Japan emerged as the largest creditor country in the world; Tokyo overtook New York, becoming the largest international financial market; the land price of the imperial palace in Tokyo was worth more than

5 Indeed, comparing the period of high growth with the crisis of the 1990s provides a sharp contrast. It does not, however, help us enough to reveal the theoretical significance of this difference. The reason is that as long as there is a bubble, the burst is inevitable. Therefore, what is important is not why the bubble bursts or how badly it bursts but rather why the bubble occurs in the first place.

that of the entire state of California; Japanese investments were often the focus of intense interest in the North American mass media; and, after all, the prices of both stocks and land rose sharply, leading directly to the bubble. Trade- and production-related issues attracted great international attention in the 1980s. However, the most profound changes in the 1980s – not only in the Japanese economy but also in the international economy – were the emergence of financial and monetary issues and their interweaving with trade and industrial policy issues (Arrighi 1994; Frieden 1987; Gilpin 1987, 2000; McKinnon and Ohno 1997; Murphy 1996; Strange 1986). As the 1985 Plaza Accord indicates, even the means of reducing the U.S. trade deficits with Japan were no longer limited to strengthening the competitiveness of American corporations or opening Japan's domestic markets; fiscal and monetary policies began to play an important role.

This study of the reversion of the Japanese economy from prosperity to stagnation adopts a kind of reverse logic. The existing literature, influenced by the research paradigm of trade and production, tends to treat the Japanese economic system as a successful model in the high growth period, a system that soured only after it became mature or after its strong competitiveness resulted in overproduction by the world capitalist system; Japanese politics is perceived as successfully maintaining a national consensus to promote exports during the high growth period, an approach that failed only after the socioeconomic alliances changed the electoral pattern. In contrast, I take the rise and the burst of the bubble as the starting point of theoretical reasoning. Rather than beginning with how the Japanese model was successful in promoting trade and production and then examining how this successful model was made obsolete by the structural changes beginning in the early 1970s, I derive my analytical framework by focusing on the institutions and mechanisms that sustained the bubble of the 1980s and reexamining their conditions during the high growth period, asking these questions: Did these institutions and mechanisms exist before? If they did, why did they not cause any major problem to the Japanese economy during the high growth period? What environmental changes made these factors a problem in the 1980s?[6] By

6 Both Brenner (1998, 79–82) and Pempel (1998, 65–73) discussed the impact of Japanese economic institutions on the high growth period. However, they attributed the dynamics of the reversion to structural changes in both international and domestic economies. In the main thrust of their arguments, they paid less attention to, or at least failed to theorize on, the impact of these economic institutions on the reversion of the Japanese economy. In contrast, Katz (1998, 218–223) touched on some of the institutional impact on the rise of the bubble but did not trace this impact on the period of high growth. Stated differently, these authors have made a structural argument with institutional components. In contrast, I make an institutional argument with structural components, suggesting that the structural changes were nurtured, developed, and triggered by the intrinsic dilemmas contained in the international economic order and the domestic economic system, and that the structural changes in turn led to further institutional changes, including both adaptation and crisis.

applying the logic of reverse thinking, we can arrive at a set of coherent variables that have contributed to both the high growth and the bubble, and in this way we avoid using different variables to explain different stages. As a result, we can not only reveal the causal mechanisms of the reversion but also shed light on how the high growth was really sustained.

Emphasizing the financial and monetary side of the Japanese economy does not mean rejecting the importance of issues related to trade and industrial policy. Rather, it means reexamining these issues from a new angle. My emphasis is on how the innovation in production technology was financed in the 1950s and 1960s, through what mechanisms the innovation triggered the high-speed economic growth, what role the state really played in the process of industrial finance, and, more importantly, what it was in the financial and monetary institutions' design that promoted high growth but also contained the seeds of the rise of the bubble. The existing literature highlights the causal relationships between strong coordination in the Japanese economic system and Japan's success in achieving economic growth, and between the nation's highly egalitarian system of distribution and the resilience of the welfare society. A reexamination of the trade and industrial policy issues from the standpoint of financial and monetary issues, however, implies three other possibilities. First, these relationships may have been more co-relational than causal; second, although these relationships were causal, what worked in the past may not have worked in a new environment; and third, although the relationships were causal, the institutional configuration of the Japanese economic system that sustained these relationships also might have involved major tradeoffs.

Comparing the high growth period with the bubble and reexamining the trade and industrial policy issues from an angle of financial and monetary issues help us to capture two profound changes in the long-term movement of capitalist economies since the early 1970s: the shift in the cycle of capital accumulation from the expansion of trade and production to the expansion of finance and monetary activity, and the shift in the major policy paradigms in advanced capitalist economies from social protection to the release of market forces.[7] Unlike the structural changes along a leaner direction conceptualized by the three studies discussed earlier, the two shifts I discuss here have taken place repeatedly in the long-term movement of capitalist economies.

To put these shifts into perspective, let us take a brief look backward. Historically, capitalist economies have experienced repeated cycles of capital

7 The discussion on social protection or welfare state throughout this book is limited to the issue of unemployment, although social protection also involves other issues such as pensions and health care.

accumulation under each hegemonic order. In each cycle, according to Giovanni Arrighi (1994, 300; see also Arrighi and Silver 1999, 31), after a major expansion of trade and production, over-accumulation of capital and intense interstate competition for mobile capital would lead to an expansion of finance and monetary activity. In the postwar expansion of trade and production in 1950–1971, corporations in advanced industrialized countries invested heavily in fixed capital, but they faced vigorous competition from the latecomer countries in industrialization, and that led to the decline of corporate profitability starting in the early 1970s (Arrighi 1994; Arrighi and Silver 1999; Brenner 1998). Driven by what John M. Keynes (1920, 25) calls “the law of diminishing return,” the expansion of finance and monetary activity became an alternative means to pursue profits, leading to widespread bank lending to the Third World and the growth of the Eurodollar markets (Hirst and Thompson 1996, 5). Meanwhile, the need to create new financial instruments to help the private sector hedge the risks of foreign exchange strongly demanded the removal of the regulatory barriers that previously restrained the free flow of capital across national borders (Eatwell and Taylor 2000). This does not mean that the expansion of trade and production was completely replaced by the expansion of finance and monetary activity; in fact, trade-to-GDP ratios in the advanced countries continued to increase. Rather, it means that the national economic systems began to face a completely new environment. Because “money’s fructifying, enabling power for good [is] matched by its terrible disruptive, destructive power for evil, [and] mismanagement of money and credit [is] more dangerous than protectionism in the trade policy” (Strange 1986, vi–vii), sooner or later the expansion of finance and monetary activity will lead to a major crisis of capitalist economies on the global scale, a crisis in which the old international economic order is destroyed and a new one is created. Such a cycle has happened under all three major hegemonies – the Dutch, the British, and the American – in the history of capitalism (Arrighi 1994, 300). In this sense, what we know today as the globalization of production and the globalization of finance represent two different stages in the cycle of capital accumulation, with the globalization of finance signaling an increasing instability in the international economic order. Seen in such a context, what happened in Japan during the past two decades would go far beyond an isolated case in which crony capitalism fell into a major crisis; a much larger process took center stage, one that shows that it was the increasing free flow of capital that produced great instabilities in the international economy. The rise and burst of the bubble in Japan was neither the first – inasmuch as it was preceded by Latin America’s Southern Cone crisis of 1979–1980 and the developing country debt crisis of 1982 – nor the last, inasmuch as it was followed by the Mexican crisis of 1994–1995, the Asian crisis of 1997–1998, the Russian crisis of 1998, and the Brazilian crisis of 1999 (Eatwell and Taylor 2000, 5).

Another profound change after the early 1970s was the shift in the long-term movement of capitalist economies from social protection to the release of market forces. Karl Polanyi ([1944] 1957) pointed out a long time ago that capitalist economies were driven by two counter forces: efforts in support of social protection and efforts in support of releasing market forces. In *The Great Transformation*, Polanyi demonstrates how the efforts to free up market forces starting in the late nineteenth century eventually led to the Great Depression, and how the efforts in support of social protection led to the rise of fascism, the New Deal, and socialism in the 1930s. I argue that the Polanyi framework can be extended to the second half of the twentieth century. Indeed, the fate of the Japanese economy in the twentieth century was shaped by a cycle of the birth, development, and deterioration of what Paul Krugman (1999a, 1999b) calls "depression-preventing" mechanisms; these mechanisms were established following the Great Depression and World War II in both the international economic order and national economic systems. The deregulation efforts in the banking industry soon spread over many industries. The shift from the expansion of trade and production toward the expansion of finance and monetary activity provided the dynamics of the shift from social protection to the release of market forces, and the release of monetary controls directly enhanced the power of market forces, causing deterioration in institutions designed for social protection. From the Polanyian perspective, the significance of the early 1970s as the turning point in the Japanese economy runs much deeper. It is not simply a starting point for the yen's appreciation or the cartelization of the Japanese economy. Rather, the early 1970s reflect a great transformation in which the freeing up of market forces became a powerful counter movement to the postwar policy of social protection in advanced industrialized countries, leading to a conservative revolution represented by the widespread adoption of deregulation, liberalization, and privatization programs. These programs have produced a "global squeeze" in jobs and wages in advanced industrialized countries (Longworth 1998). As a result, inequality is rising and different social groups are "growing apart" (Fishlow and Parker 1999).

AN INSTITUTIONAL EXPLANATION

Why did these two shifts take place? Through what causal mechanisms did they cause the reversion of the Japanese economy from prosperity to stagnation?

In contrast to the authors of structural accounts, I offer an institutional explanation of the origins of these two major shifts in the long-term movement of capitalist economies, emphasizing an intrinsic dilemma in the postwar international economic order.

The existing literature on institutional change often highlights the effects of exogenous shocks, which are best exemplified by Stephen Krasner's (1984) metaphor, "punctuated equilibrium." Exogenous shocks can block the reproduction of the institutional patterns and thus induce change, but they alone cannot effectively explain the causal mechanism that leads to the institutional change. Institutional change does not take place overnight, and in many cases it takes a long time. The metaphor of punctuated equilibrium simply leaves unexplained the internal institutional process between the point of exogenous shocks and the point of institutional change. Moreover, exogenous shocks do not simply block the reproduction of the institutional pattern. Rather, they often cause maladaptation by inducing the institution to follow the old institutional logic in a completely new environment.

The concept of intrinsic dilemma aims at revealing the causal mechanism that links the exogenous shocks to the institutional change. By "intrinsic dilemma" I mean a built-in contradiction in the institutional logic. "Institutional logic" refers to "a set of material practices and symbolic construction . . . which constitutes its organizing principles" (Friedland and Alford 1991, 248), which "are symbolically grounded, organizationally structured, politically defended, and technically and materially constrained, and hence have special historical limits" (Friedland and Alford 1991, 248–249; see also Hollingsworth and Boyer 1997b, 2). The intrinsic dilemma is that because the specific historical environment during the period of institutional formation often highlights the importance of one single task among many faced by the institution, overdevelopment of strength in solving one problem in the institutional logic often results in a weakness in solving others (Kester 1997). This situation often creates a logical contradiction because during its lifetime an institution often faces changing task environments. When it does, any weakness in dealing with competing tasks can lead to the malfunction of the institutional logic. This intrinsic dilemma, moreover, tends to worsen over time because institutions tend to tackle new problems by relying on the established institutional logic. When they reproduce themselves along a single direction, their actions deepen the contradiction in the institutional logic.

This kind of intrinsic dilemma may lead to institutional change in two ways. First, over the long run the weakness of the institution in solving other problems can create structural conditions that further exacerbate the mismatch between the institution's strength and its task environment. When its