

1

Introduction and Overview

Introduction

The evolution and transition of Japan's economic and political institutions during the entire post–World War II period is remarkable for two reasons. First, Japan completed reindustrialization and reestablished prewar economic growth trends in record time. By the 1970s, Japan emerged as the second largest economy in the world. Japan remains a major component of the world economy with one of the world's higher standards of living for its population.¹ Second, following the completion of reindustrialization, Japan's economic and political development exhibited wide fluctuations in performance. After a short but turbulent period of economic distress in the early 1970s, Japan achieved impressive economic, financial, and political stability from 1975 to 1989. The perception of Japan's economic invincibility became widespread during this period. Starting in 1990, however, Japan experienced intense economic, financial, and political distress. The economy and financial system continued to decline or stagnate until 2005. Despite economic recovery by the mid-2000s, Japan continues to face lingering economic and political problems.

¹ World Bank estimates of GDP, gross national income, and population can be found at <http://www.worldbank.org>, Quick Reference Tables. World Bank GDP rankings for 2006 in terms of Purchasing Power Parity (PPP) indicate that Japan is now the fourth largest economy in the world after the United States, China, and India. The 2006 data show Japan only slightly smaller than India but significantly smaller than the United States or China. PPP takes into account differences in price levels between countries so that an international dollar has the same purchasing power over GDP as a U.S. dollar has over GDP in the United States. In terms of 2006 real GDP adjusted for market exchange rates, Japan remains the second largest economy in the world.

The record of Japan's economic performance since the early 1970s and how Japan has adapted to internal and external forces of change have offered a number of important insights into the development process in general.² Japan has become a major case study and has influenced economic and political institutions in many countries as they either tried to emulate Japan's economic success or learn from Japan's failures.

The general outline of Japan's postwar development can best be understood by dividing the postwar period into four distinct periods. The first period, from 1945 to 1950, is one of *establishing economic stability*. During this period, Japan focused on stabilizing its economic and political institutions following the end of World War II. Serious efforts to stabilize the economy commenced in 1949 with the Dodge Line austerity program designed to reduce inflation, balance the budget, redesign the Bank of Japan (BOJ) to render it less susceptible to pressure to expand the money supply, and establish a fixed-exchange rate at ¥360 to \$1.00. The second period, from 1950 to 1970, is one of *reindustrialization and relative political stabilization*. Japan achieved reindustrialization in record time because of the combined effect of the Dodge Line policies, the stimulative impact of the Korean War starting in June 1950, and the process of political stabilization starting in 1955 when the Liberal Democratic Party (LDP) assumed power. The period from 1950 to 1970 is frequently referred to as the High Growth Period (HGP) because annual real GDP growth averaged about 10 percent³ with moderate inflation of about 5 percent. This is a relatively low inflation rate for such a rapid pace of real output growth. The third period, from 1970 to 1980, is one of *new environment* during which

² There is an immense literature on Japan's pre- and postwar economic development, some of which will be cited in subsequent chapters; however, a general overview of economic development through the late 1980s is provided by Ito (1992) and Yamamura and Yasuba (1987). Hoshi and Patrick (2000) provide a number of perspectives on the "lost decade" of the 1990s. Cargill, Hutchison, and Ito (1997 and 2000) review Japan's postwar financial and monetary development.

³ Some observers regard 1955 rather than 1950 as the start of the HGP because the size of the economy did not achieve the prewar peak until about 1955. The starting year of 1950 used in this discussion is based on three considerations; first, the Dodge Line established a "takeoff" position for the Japanese economy; second, the start of the Korean War in June 1950 significantly stimulated the Japanese economy as Japan was used as a base of operations by the United States and allies; and, third, real GNP started rapid growth after 1949 (Ito, 1992, pp. 44–45). According to data cited in Ito (1992, p. 45), the average growth of real GDP from 1953 to 1970 was approximately 9.4 percent.

The Pretransition Period: Developments up to 1980

3

Japan's economic institutions came into conflict with a new set of economic, political, and technological forces. These forces set into motion a transition toward a "new" Japan that differs from the "old" Japan. The fourth period, starting around 1980, is one of *transition* toward a more market-directed economy and transition in the political regime. The transition continues to the present and is the subject of this study.

The wide swings in economic and political performance render the fourth period remarkable. In the 1980s, Japan seemed invincible in terms of economic, financial, and political stability, whereas in the 1990s and the beginning of the new century, Japan seemed unable to do anything right. The distress by the late 1990s illustrated to all but a few that the "old" Japan was no longer viable. Japan needed to adapt its economic and political institutions to a new environment and, in the process, the old social contract between the government and the population began to unravel.

These four periods – economic stabilization, reindustrialization and relative political stability, new environment, and transition – are pedagogical perspectives to conceptualize the main shifts and time periods of Japan's economic and political performance since the end of World War II. The starting and ending points are not precise, but they are close enough to identify the major shifts in economic, financial, and political institutions in Japan. The transition period is the most significant because it represents a dramatic shift in how Japan operates. The first three periods are collectively referred to as the pretransition stages of postwar Japan.

The pretransition stages of postwar Japan have been discussed extensively from both an economic and political perspective; however, it is important to summarize the highlights of the events leading up to the fourth period – the transition of Japan since 1980. The following is a brief summary of postwar Japan up to 1980.

The Pretransition Period: Developments up to 1980

Many of Japan's economic and political institutions in the postwar period up to 1980 continued to develop along trends established in the prewar period. The trends, however, were modified by the war experience and the Allied Occupation of Japan that lasted from 1945 to 1952.

Establishing Stability, 1945–1950

The immediate objective of the postwar government was to shift from wartime to peacetime production, absorb large numbers of returning military, and stabilize an economy marked by hyperinflation, unemployment, and government deficits. Japan's economic stabilization policies commenced under the guidance of a competent and strong bureaucracy. Economic and financial instability was addressed in 1949 by a series of policies collectively referred to as the Dodge Line, named after Joseph Dodge, who served as economic advisor to the Allied Occupation. The Dodge Line austerity policies would have generated significant economic cost in Japan in the short run; however, the start of the Korean War in June 1950 stimulated the Japanese economy so that Japan was able to establish a "takeoff" platform for reindustrialization and avoid the recession that normally would be expected from implementing the Dodge Line policies.

Democratization and the establishment of a new and stable government was the primary political objective of this period. Japan became fully democratic with free elections, free party competition, and universal suffrage after the new constitution came into effect in 1947. The constitution deprived the emperor of political power, and he became a symbol of state. Japan also was demilitarized completely.

Reindustrialization and Political Stabilization, 1950–1970

By 1950, the economy stabilized. The next two decades would witness a reindustrialization process in record time, accompanied by economic and political stability. This performance was achieved with a set of economic and political institutions that in many respects were a continuation of prewar trends. The bureaucracy was an important influence over the economy. The politicians would set a broad, general course for the nation, whereas bureaucrats crafted and implemented the economic policy to achieve the goal of economic recovery and growth. Japan developed a set of economic institutions designed to limit risk and bankruptcy through mutual support systems, nontransparency, long-term "customer relationships" rather than short-term "market-relationships," and relied on mercantilist trade policy. These clearly were a continuation of trends established in the prewar period.

Figures 1.1–1.5 provide an overview of Japan's economic performance for a major part of the postwar in terms of real and nominal

The Pretransition Period: Developments up to 1980

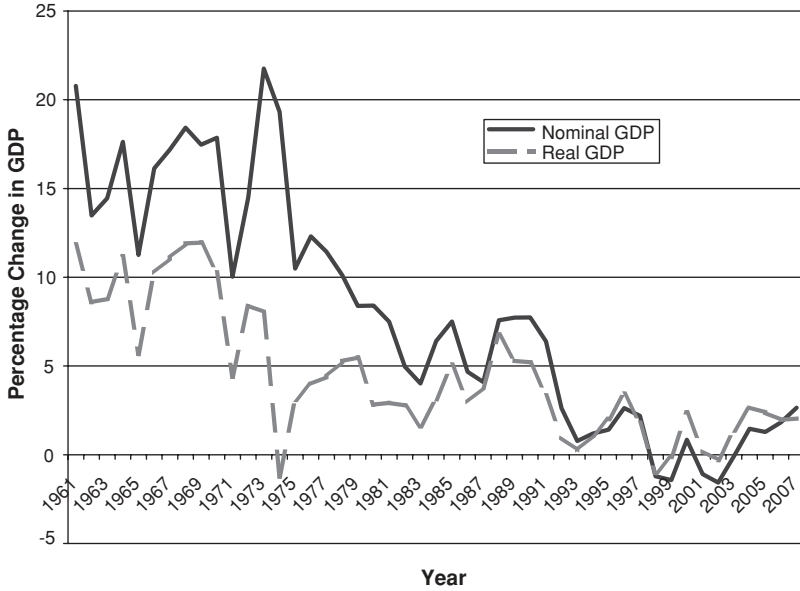


Figure 1.1. Annual Percentage Changes in Nominal and Real GDP, 1961 to 2007. Source: The OECD *Economic Outlook* (various years). Note: The values for 2006–07 are projections.

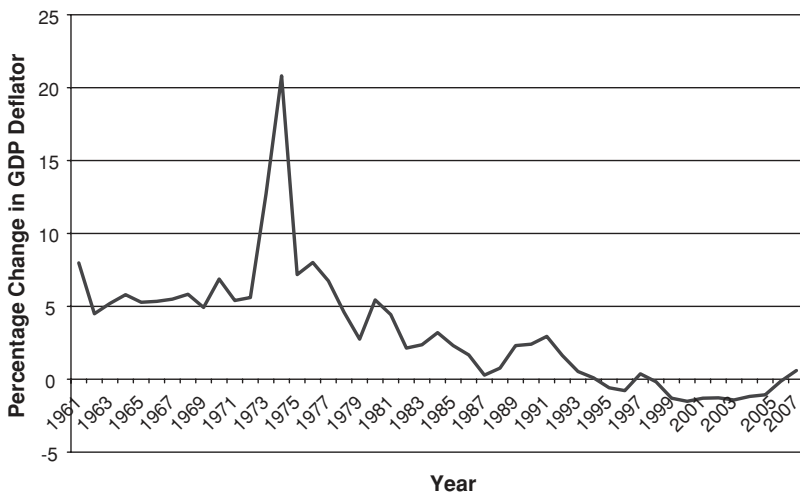


Figure 1.2. Annual Percentage Changes in GDP Deflator, 1961 to 2007. Source: The OECD *Economic Outlook* (various years). Note: The values for 2006–07 are projections.

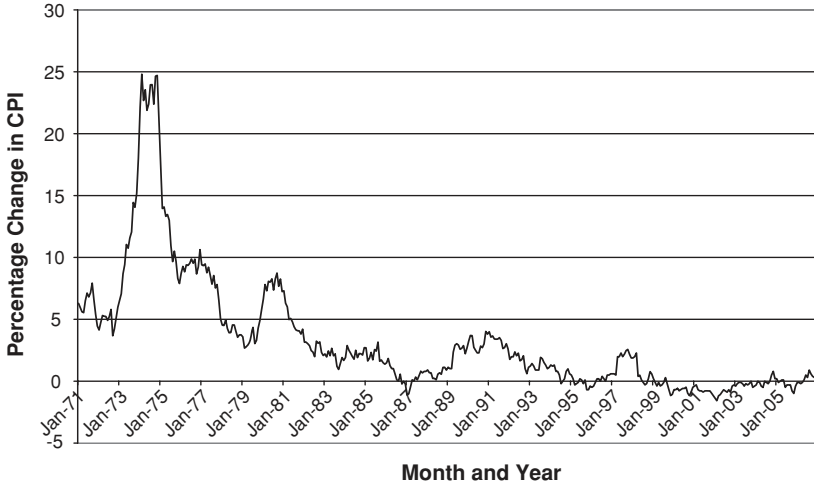


Figure 1.3. Annual Percentage Changes in the CPI from Year Ago, January 1971 to December 2006. *Source:* Ministry of Internal Affairs and Communications, Statistics Bureau, Consumer Price Index, <http://www.stat.go.jp/english/data/cpi/index.htm>.

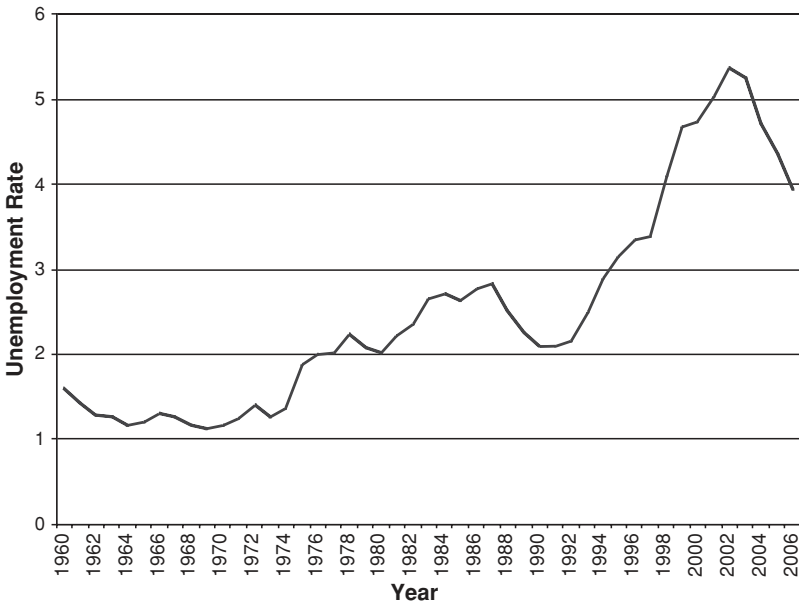


Figure 1.4. Unemployment Rate, 1960 to 2007. *Source:* The OECD *Economic Outlook* (various years). *Note:* The values for 2006–07 are projections.

The Pretransition Period: Developments up to 1980

7

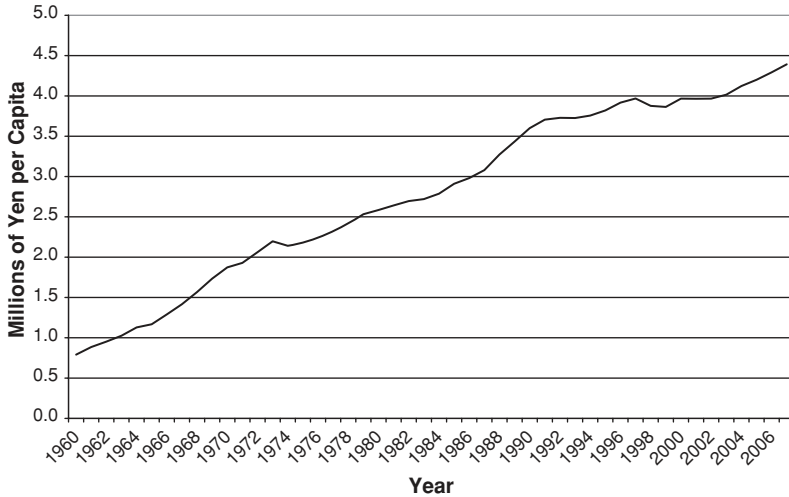


Figure 1.5. Real GDP per Capita, 1960 to 2007. *Source:* 1960–1979: GDP from Figure 1.1 and population from Ministry of Internal Affairs and Communications, Historical Statistics of Japan, Population; <http://www.stat.go.jp/english/data/chouki/02.htm>; 1980–2007: International Monetary Fund, World Economic Outlook Database, Japan, <http://www.imf.org/external/pubs/ft/weo/2007/01/data/index.aspx>. *Note:* The values for 2006–2007 are estimates.

GDP growth, GDP deflator and CPI inflation, unemployment rate and standard of living measured by real GDP per capita. The macroeconomic performance, the rise in the standard of living, and the relative political stability exhibited by the 1960s vindicated Japan's approach. The political system started its transition to a stable system in 1955, when two conservative parties merged to form the LDP, and the left and right wings of socialist parties merged to become the Japan Socialist Party (JSP). The new party system built around the two parties formed the basis of the so-called 1955-System, which lasted until 1993. In the 1955-System, the LDP controlled the Japanese government without interruption, with the JSP as the distant second largest party. Other small center-left opposition parties usually allied themselves with the JSP⁴ in the earlier periods; however, from the end of the 1970s to 1993, they cooperated with the LDP more frequently.

⁴ The JSP later changed its name to the Social Democratic Party of Japan (SDP); hence, JSP is appropriate when referring to its origin while SDP is appropriate for references to later periods.

The general contours of Japan's industrial goals and approaches to achieving those goals did not experience wide shifts during the HGP, because of the LDP's one-party rule, the absence of political divisions affecting policy, and stable management by a bureaucracy staffed with permanent officials. In many ways, the industrial goals were a continuation of prewar objectives of first catching up with Western countries in economic development and then achieving superiority with Western countries, minus the goal of achieving military superiority to the West. This industrial objective had first been adopted around the time of the Meiji Restoration in 1868, when the country realized that it lagged far behind the West in industrialization and militarization after two and a half centuries of isolationist policy by the Edo government, which had ruled Japan between 1603 and 1867 (Tokugawa Period).

New Environment, 1970–1980

Three events impacted Japan in the 1970s that would induce and influence Japan's transition after 1980. First, the economic stability of the previous two decades ended with a short but turbulent period in the early 1970s of high inflation, referred to as "wild inflation." An unprecedented oil price shock in 1973, combined with several previous years of expansionary monetary policy, drove up inflation rates on a monthly basis to 30 percent per annum, adversely affecting economic growth. Japan weathered the oil shock reasonably well, and by 1975 the economy stabilized; however, the 1973 oil shock and another oil crisis in 1979 lowered Japan's natural growth path.

Second, Japan's reindustrialization process was completed by the late 1960s. The resulting decline in the rate of domestic investment spending, combined with higher energy prices, reduced the 10 percent growth rate of the HGP to the 3 to 5 percent range. Slower growth would have important impacts on Japan. Slower growth initiated financial liberalization, reduced revenue growth and contributed to government deficits, and began to alter the implicit social contract between the government and Japanese households. Japanese households had been willing to forgo access to the financial system as a source of funds (consumer and mortgage credit), place their substantial savings in government controlled low-interest financial assets, and support a producer-oriented public policy in exchange for high

The Pretransition Period: Developments up to 1980

9

rates of real income growth and economic security. Although households continued to have faith that the government would guarantee economic security, the slower growth environment began to weaken a major pillar of the social contract that emerged after World War II – high and secure economic growth.

Third, Japan found itself in a new operating environment as the world started experiencing new economic, political, and technological developments in the 1970s. In varying degrees, these developments induced liberalization or “neoliberal” policies in a wide range of developed and developing economies.

The new economic environment was characterized by higher energy prices, uncertain supplies of energy, high and uncertain inflation rates, collapse of the fixed exchange rate system in 1973, and financial disruptions caused by government efforts to impose interest rate controls and other limits on the flow of funds. The new economic environment set into motion a financial liberalization process that eventually would affect most of Japan’s economic and political institutions because it clashed with Japan’s rigidly controlled, internationally isolated, and regulated economic and financial system.

The new political environment was characterized by a general shift in attitudes in industrial democracies away from collectivist approaches to managing the economy such as that adopted by Japan toward market-directed resource allocation systems as in the United States. This in no way is meant to imply that the United States was a model of individualism, but of all of the major industrialized economies during this time, the United States relied less on collectivist approaches to managing the economy than any major country. The collectivist approach had been found wanting in many places by the 1980s and, as a result, a new political attitude emerged that emphasized open and transparent markets, less government interference, and more open and democratic political institutions. The pace and extent of liberalization varied from country to country and the process was more often driven by market innovations rather than government innovations. In fact, it was market innovations especially in the financial sector that forced governments to change regulations. The process was well under way in the United States by the 1970s and reinforced by the election of President Ronald Reagan in 1980. Margaret Thatcher’s election as prime minister in 1979 was a turning point in the United Kingdom. Japan was not immune. Japan experienced increasing demands from

the United States, the United Kingdom, and Europe to cease its mercantilist policies, open its real and financial sectors to the rest of the world, and in general adopt a more market-oriented set of economic institutions.

The new technological environment was characterized by advances in computer and telecommunication technology, making it increasingly difficult for governments to impose binding constraints over the financial system or to regulate the inflow and outflow of capital. The international financial system was becoming increasingly flexible, and the collapse of the fixed exchange rate system made it difficult for export-oriented countries such as Japan to remain isolated from the international financial system.

The new economic, political, and technological environment, combined with slower long-run growth potential, set the stage for the transition of Japan's economic and political institutions, which continues to the present day. The transition after 1980 started with limited financial liberalization, which appeared successful in the 1980s. Flaws in the process, combined with policy errors by the BOJ and the Ministry of Finance (MOF), brought Japan to an abyss of deflation, recession, and the insolvency of its banking system in the late 1990s. As a result, the nature and extent of the transition changed dramatically.

The Transition since 1980 in Broad Perspective

The past three decades have witnessed major changes in Japan's economic and political institutions. Although Japan has and will continue to develop its own model of the market and democracy conditioned by its culture, history, and perception of its place in the world, the newly evolving economic and political institutions will continue to become more open, competitive, transparent, and responsive to a different set of socioeconomic interests than in the past. The ongoing transition has and will affect the social contract between the government and its citizens.

The transition in broad perspective can be considered in terms of four periods defined by Japan's economic and financial performance, response of the government to the new operating environment, policy outcomes of that response, and the extent to which Japan's economic and political institutions changed. The transition is decomposed into phases defined both in terms of time sequence and policy outcomes.