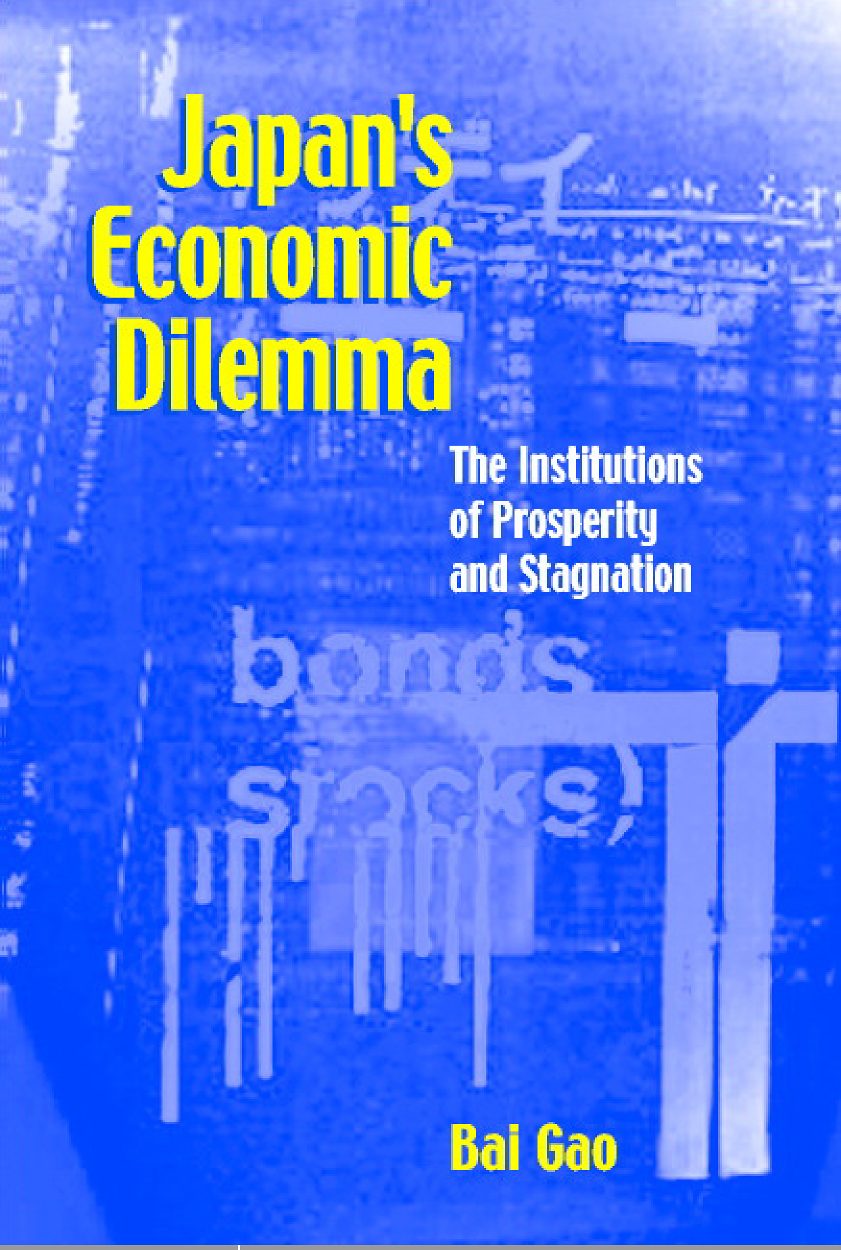
Japan's Economic Dilemma

The Institutions of Prosperity and Stagnation

Bai Gao



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The Japanese economy, after decades of seemingly unsurpassable competitiveness, experienced a major crisis in the 1990s. The depth of the crisis has been as remarkable as Japan's renowned meteoric success. Economies rise and fall, to be sure; but the magnitude of the Japanese economy's swing within such a short time, and in the absence of major wars, is unprecedented. Observers of Japan are faced with a challenging question: How can one explain Japan's seemingly abrupt reversal from stunning prosperity to dismal stagnation?

Bai Gao, in this most illuminating and broadly comprehensive analysis of Japan's economic story, not only explains the reversion but also goes beyond other analyses to demonstrate how the same economic institutions could produce both stunning international economic success *and* the subsequent, intractable slump of the 1990s.

As with several recent studies of Japan's economic reversal, Gao finds seeds of the dilemma in Japan's failure to adjust the emphases of its postwar economic policy-making to changing world market conditions in the 1970s. But that account alone fails to explain why the path of Japanese economic growth has not been one long decline since the 1970s. Unlike other analyses, Gao's institutional explanation accommodates the inconvenient fact of Japan's spectacular growth spurt in the 1980s. By comparing the internal and external factors that sustained miracle growth in Japan in the 1960s and 1970s with the factors that led to the bubble economy of the late 1980s, Gao sheds new light on the long-term internal tensions in the Japanese economic system and describes how and why they came to create problems and finally to "burst the bubble" in the 1990s.

Scholars and students of the Japanese economy and politics, economic sociologists, economic analysts, and observers of globalization will find much useful and important information in this book. Those who have been following the lively debate over "What became of the Japanese miracle?" will be rewarded by Gao's richly detailed, historically informed, and multilayered contribution. More generally, his explanation of the ways in which Japan's internal economic policies and structures have clashed and merged with global economic developments enriches our understanding of the recent history of capitalism.

Bai Gao is Associate Professor in the Department of Sociology at Duke University. He is the author of *Economic Ideology and Japanese Industrial Policy: Developmentalism from 1931 to 1965* (Cambridge University Press, 1997), which received the 1998 Hiromi Arisawa Memorial Award for Best Book in Japanese Studies from the Association of American University Presses.

JAPAN'S ECONOMIC DILEMMA

THE INSTITUTIONAL ORIGINS OF PROSPERITY AND STAGNATION

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To the Memory of Marius B. Jansen (1922–2000)

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Figure 4.1 (this volume) is a reprint of Figure 4.8, "Japan Invests Much More than Others," from *Japan, The System that Soured* by Richard Katz, ©1998 by M.E. Sharpe. Used by permission of the publisher M.E. Sharpe.

Table 6.1 (this volume) is reprinted from Michael Loriaux et al., *Capital Ungoverned: Liberalizing Finance in Interventionist States*. Copyright ©1997 by Cornell University. Used by permission of the publisher, Cornell University Press.

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 socio-economic 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 weakness in solving other problems becomes critical to the institution's survival, it may break down, triggering further structural changes in the environment. Often, understanding the dynamics of institutional change requires an examination that extends beyond the period of crisis. If we use the metaphor of an earthquake to represent the relationship between the intrinsic dilemma in an institution's logic and the crisis of the institution, it is the earthquake that we see; but it is the geological movements of tectonic plates – the explanatory device – that have been causing the buildup of the pressures that led to the quake, often for a long time.[8] Second, when the environment in which a national economic system, as an aggregation of institutions, is configured remains unchanged, the system tends to be sustained by the complementarity of homogeneous institutions and mechanisms (Aoki and Okuno 1996; Hollingsworth and Boyer 1997a; Okuno 1993). When the environment changes drastically, however, the institutions and mechanisms may no longer complement each other. Under such circumstances, the institutional logic of the national economic system may begin to malfunction.[9] That can create a major crisis for the institution.

The two shifts – from the expansion of trade and production to the expansion of finance and monetary activity and from social protection to the release of market forces – were not automatic. Rather, they were triggered by major changes in the international monetary and trade regimes induced by their intrinsic dilemmas. In his analysis of the previous wave of globalization in the early twentieth century, John Keynes pointed out the serious neglect of the intrinsic contradiction in capitalist economies on the eve of a global crisis (1920, 3):

> Very few of us realize with conviction . . . the intensely unusual, unstable, complicated, unreliable, temporary nature of the economic organization. . . . We assume some of the most peculiar and temporary of our late advantages as natural, permanent, and to be depended on, and we lay out plans accordingly. On this sandy and false foundation we scheme for social improvement and dress our political platforms, pursue our animosities and particular ambitions, and feel ourselves with enough margin in hand to foster, not assuage, civil conflict in the European family.

After World War II, advanced industrialized countries, under the leadership of the United States, established the Bretton Woods system and the

8 Roger Haydon used this metaphor to express his understanding of my argument in his comments on this chapter. I want to thank him not only for this metaphor but also for other comments.

9 Roger Friedland and Robert R. Alford (1991, 256–259) use the term "institutional contradiction" to reflect a similar phenomenon, but they emphasize the political dimension by arguing that "the premise of institutional contradiction derives from class theory."

General Agreement on Trade and Tariffs (GATT) system to promote social protection and to sustain the expansion of trade and production. This international economic order, however, contained the Triffin dilemma: On the one hand, the Bretton Woods system and the GATT system provided the ally countries of the United States with great opportunities to export their products – sustained by the undervalued currencies relative to the dollar – and to increase their trade surplus with the United States. On the other hand, the United States, as the key currency country responsible for sustaining confidence in the dollar, could not take any action to adjust trade deficits through the exchange rate. The United States enjoyed the benefits of the dollar as reserve, transaction, and intervention currency, thereby extending its economic and political privileges and freeing itself from concern about its balance of payments in the conduct of its foreign policy or the management of its domestic economy; but any devaluation of the dollar to improve American competitiveness would immediately have been wiped out by parallel devaluation of other currencies. Sooner or later, Robert Triffin predicted, either the system would collapse or alternative ways would be found to address this issue (Gilpin 1987, 137; Triffin 1960, 1964). Disregarding this dilemma, unfortunately, advanced industrialized countries pushed the expansion of trade and production beyond the capacities of the postwar international economic order. The increasing holding of the dollar outside the United States eventually forced the U.S. government to unlink the dollar and gold. That action led to the collapse of the Bretton Woods system.

The collapse of the Bretton Woods system triggered the shift from the expansion of trade and production to the expansion of finance and monetary activity. When governments maintained fixed exchange rates, the private sector was free from foreign exchange risk. When the system collapsed, as John Eatwell and Lance Taylor (2000, 2) point out, "risk was privatized." Two needs created by the collapse of the Bretton Wood system provided the incentive for various interest groups in advanced industrialized countries to assert the need for deregulation of international capital flows: First, after risk was privatized, those who traded in foreign markets faced the overwhelming need to hedge against the costs imposed on them by fluctuating exchange rates. They "needed to be able to diversify their portfolios at will, changing the mix of currencies and financial assets both at present and in the future in line with the changing perception of foreign exchange risk." Second, "once Bretton Woods collapsed and significant fluctuations in exchange rates became commonplace, opportunities for profit proliferated, regulatory structures inhibiting flows of capital were challenged as 'inefficient' and 'against the national interest,' and the modern machinery of speculation was constructed" (Eatwell and Taylor 2000, 2).

The privatization of risk demanded the creation of new financial instruments, which in turn required removing many of the regulatory barriers that had been created after the Great Depression and World War II to prevent depression. The removal of the regulatory barriers triggered the shift of capitalist economies from the expansion of trade and production to the expansion of finance and monetary activity. Deregulation, liberalization, and privatization, however, were not limited to the financial industry. They became the leading topics of rhetoric in public policy discourse for the entire economy. When regulatory barriers were removed in many industries, the depression-preventing regime deteriorated. Capitalist economies began to change gears from social protection to the release of market forces. Reflecting these two profound changes, the United States, facing increasing trade deficits, was forced to end its policy of asymmetric cooperation with Japan in international trade, a policy whereby Japan was able to export its products to the international markets while keeping its own domestic markets closed. The United States demanded greater access to the Japanese markets.

In contrast to explanations of the reversion of the Japanese economy that are based on domestic policy, my explanation focuses on the major impact of the international economic order on the domestic policy environment. Moreover, in contrast to those studies in which the primary impact of the international environment on the Japanese economy during the high growth is thought to be the Cold War, I explore the direct causal mechanism that linked the international economic order and Japan's domestic economic institutions.[10]

In 1950–1971, under the Bretton Woods system, a fixed exchange rate and rigid control over the free flow of capital across national borders enabled Japan to promote its own economic growth without being influenced by the financial policies of other countries. Restrained by the Dodge plan, which emphasized the control of inflation, the Japanese state could not continue to practice its expansionary fiscal policy in the 1950s and 1960s. Instead, it adopted a very important policy mix of an expansionary monetary policy to promote economic growth and a deflationary fiscal policy to control inflation. To make the expansionary monetary policy work, the Japanese state not only tried to allocate resources strategically through its industrial policy (a strategy emphasized by the existing literature) but also performed an important

10 This does not mean that the Cold War is not important but rather that the Cold War alone is not sufficient to explain what happened in the 1970s and 1980s. The Cold War did not end until the very end of the 1980s. Yet the bilateral trade frictions between the United States and Japan started in the late 1960s and intensified in the 1970s and especially in the 1980s, well before the Cold War was over. As I discuss in Chapters 2 and 5, the United States practiced asymmetric cooperation with its allies not only to support its strategic interests during the Cold War but also to build a multilateral international trade regime.

insurance function by reducing investment risks for private banks and corporations. Three policies – the so-called convoy administration practiced by the Ministry of Finance (see Chapter 4), the stable supply of credit by the Bank of Japan to major city banks, and the egalitarian distribution of foreign currency quotas by Ministry of International Trade and Industry (MITI) to big corporations – significantly reduced investment risks and enabled big corporations and banks to aggressively invest in production capacity and technological transfers (Miyazaki 1963; Morozumi 1963a). In 1950–1971, the policy mix adopted by the Japanese state also strongly influenced the Japanese pattern of social protection. Because the Japanese state adopted a deflationary fiscal policy to control inflation and sustain an expansionary monetary policy and it emphasized capital accumulation and the maintenance of a small government, it was impossible for Japan to develop a welfare state. Asymmetric cooperation with the United States within the framework of GATT, meanwhile, enabled Japan to export aggressively without opening its own domestic markets. That allowed the Japanese state to sustain employment by relying on cartels to protect medium-size and small companies and family-owned mini shops. Instead of developing a strong, government-financed unemployment assistance program, Japan relied on government regulations to protect the weak sectors of the economy and the sunset industries (those that were becoming obsolete).

After the collapse of the Bretton Woods system shifted the expansion of trade and production to the expansion of finance and monetary activity, Japan's international financial policy began to confront the Mundell-Flemming trilemma (see Krugman 1999a, 1999b; this phenomenon is also discussed in detail in Chapter 2 of this book). Japan adopted the floating exchange rate system and joined the liberalization of finance initiated by Britain and the United States. As a result of increasing the free flow of capital, Japan began to lose its autonomy in determining its fiscal and monetary policies and began to face conflicting policy objectives (McKinnon and Ohno 1997). In this new environment, the Japanese state often had trouble maintaining a good balance in the policy mix between fiscal and monetary policies. With a floating exchange rate and increasing free flow of capital, efforts by the Bank of Japan to maintain stable exchange rates through its intervention in the foreign exchange market often led to an oversupply of money. This in turn upset the balance of domestic demand and supply, while the efforts by the Ministry of Finance to reduce the trade surplus by adopting an expansionary fiscal policy often served to channel private investments to the real estate and stock markets. That triggered the bubble.

Meanwhile, the United States was no longer willing to continue asymmetric cooperation. It began to use its monetary policy to address trade issues.

The sharp increase in Japan's trade surplus with the United States directly led to increasing U.S. pressures on Japan to open its domestic markets, liberalize its finance industry, appreciate the value of the yen, and create domestic demand by increasing public spending. Under international pressures, Japan began deregulation and privatization. After the shift from social protection toward the release of market forces, the Japanese state policy also faced competing objectives. On the one hand, domestic pressure for increased government protection rose drastically after the end of the high growth period. On the other hand, international pressure for liberalization, deregulation, and privatization also built up quickly. The Japanese state often struggled between these competing policy agendas, and that increased the cost of job creation and made it more difficult to achieve the goal of maintaining equality in distribution.

In contrast to exclusively macro-level explanations, I emphasize the micro-level institutions and mechanisms that sustained the reversion of the Japanese economy in the two structural shifts. I argue that although the macro-level structural changes are powerful in explaining the general trend shared by various capitalist economies, the variations in the same two structural shifts among different industrialized countries can be better understood at the micro level. Moreover, in contrast to those studies that either focus on the cartelization of the Japanese economy or interpret the economic growth as a purely market-driven phenomenon, this book demonstrates how the efforts of coordination ended up encouraging excessive competition and how this intrinsic dilemma was responsible for both the high growth and the bubble economy.

The dilemma in Japanese corporate governance between, on the one hand, strong coordination and, on the other hand, weak control and monitoring provided the causal mechanism that led to excessive competition, a phenomenon that was critical both to Japan's high growth and to the bubble. In 1950–1971, sustained by the insurance function performed by the state in a predictable international environment, the Japanese economic system was reconfigured to strengthen coordination – a principle of economic governance that had emerged in the Great Depression and World War II for the purpose of adapting to the expansion of trade and production. "Coordination" here refers to the establishment and maintenance of contractual exchange among separate enterprises. "Control" refers to the control of shareholders over management due to the separation between ownership and management (Kester 1997), and "monitoring" refers to the mechanisms established by banks for "assessing the credit-worthiness of proposed projects; tracking the use of funds; distinguishing misuse from temporary bad luck and correcting it; as well as credible commitment to penalizing misuse as a safeguard against future misuse" (Aoki 1994, 109). At a time when the country was still suffering from a shortage of capital, strong coordination enabled Japan to successfully mobilize the national savings that sustained high growth. Strong coordination was achieved, however, at the cost of deliberately weakening shareholder control over management and weakening banks' monitoring over corporations at the micro level (Kester 1997; Miyazaki 1963; Morozumi 1963a). Protected by the state, private corporations and banks reduced their transaction costs through indirect financing, through the use of the main bank system, and through business group and reciprocal shareholding. Sustained by the permanent employment system practiced by big corporations and by multidimensional integration within business groups, strong coordination led not to a socialist, planned economy but rather to excessive competition among Japanese corporations in investing in production capacity and technological transfers. This excessive competition, in turn, triggered the high growth.

After the First Oil Shock, in contrast, banks' monitoring further deteriorated as corporations began to build financial independence, separating themselves from the main banks. In the liberalization of finance, banks' leverage over corporations was weakened because corporations began to raise capital through equity finance and *zai'tech* (financial technology). After the Plaza Accord, moreover, the mishandling of international demand resulted in not only an oversupply of money but also the adoption of an expansionary fiscal policy that shifted the incentive structure of private investments from production to the stock and real estate markets. When the state policies served to significantly increase investment risks, the weak control and monitoring that characterized Japanese corporate governance contributed directly to the rise of the bubble.

After the long-term movement of capitalist economies shifted gears from social protection to the release of market forces, another causal mechanism that led to the stagnation of the Japanese economy was the dilemma between stability and the upgrading of the economic structure. "Stability" here refers to political stability in the process of economic development, which is sustained by the rise of employment opportunity and the fall of economic inequality. The "upgrading of the economic structure" could involve actions at three levels (not necessarily simultaneously): private companies lay off surplus workers; an industry or a sector eliminates inefficient companies through corporate bankruptcy as a result of market competition; and capital and labor in an economy leave the sunset industries and enter the sunrise industries. In 1950–1971, under the protection of asymmetric cooperation with the United States, the Japanese state relied on private institutions to perform the welfare function while it concentrated on capital accumulation.

Big corporations institutionalized a permanent employment system, providing job security for their employees. Medium-size and small companies organized various cartels in an effort to restrain competition and thereby avoid bankruptcy. Meanwhile, the weak sectors and sunset industries enjoyed the protection of various government regulations. Although the persistence of this dual economic structure created significant gaps in income distribution, Japanese women played an important role in mitigating the problem of inequality in distribution, resulting in a high level of equality in distribution measured by household income, instead of individual income, in the Gini index.[11] As a marginal labor force, women entered and left the labor market flexibly according to the economic situation (Nomura 1998). By tying various political interests to the existing economic structure, Japan was able to pursue "development without losers" and to concentrate its resources in promoting economic growth (Weiss 1998).

But when capitalist economies shifted gears from social protection to the release of market forces in the early 1970s, the contingent conditions that had sustained the Japanese model of the welfare society began to disappear. The First Oil Shock ended the high growth period, the rapid appreciation of the yen put great pressure on the Japanese economy to improve efficiency, and the United States began to put strong pressure on Japan to open its domestic markets. Because Japan did not have a good unemployment assistance program, labor unions strongly demanded job security, and companies in the weak sectors and industries demanded more government protection. These demands led to the cartelization of the economy and the politicization of economic policy-making (Katz 1998; Pempel 1998). In 1971–1989, Japan was able to maintain stability along with a low unemployment rate. The cost of doing so, however, became very high because the permanent employment system forced companies to keep surplus workers, the cartels forced industries to keep inefficient companies, and government regulations forced the economy to keep sunset sectors and industries. Meanwhile, market forces were released, resulting in increased inequality of distribution as a result of the different degrees of ownership of land and stocks during the bubble of the 1980s (Nomura 1998; Tachibanaki 1998).

In contrast to the studies of the reversion of the Japanese economy based on one individual institution or policy area, I offer a comprehensive account of this process.

11 The Gini index of income or resource inequality is a measure of the degree to which a population shares that resource unequally. It is based on the statistical notion known in the literature as the "mean difference" of a population. The index is scaled to vary from a minimum of zero to a maximum of 1, zero representing no inequality and 1 representing the maximum possible degree of inequality. See Robert Leslie, in "Exploring the Gini Index of Inequality with Derive," www.agnesscott.edu/aca/depts_prog/info/math/leslie/gini.htm.

As indicated in this high-level summary of the events and discussed in more detail in the chapters that follow, I argue that the reversion of the Japanese economy against the two structural shifts in the global capitalist system in the late twentieth century was a complicated process. This comprehensive approach cannot provide all the details concerning each individual institution. It does, however, present a bigger picture. When capitalist economies show significant cross-national variations in their responses to a common challenge, it is often not the individual institutions, but rather the configuration of these institutions in the economic system, that better explains the outcome.[12] The term *economic system*, as I use it in this study, consists of multiple institutions at the national, intermediate, and corporate levels. It defines the relationships between the state and private corporations, between the state and private citizens, between banks and manufacturers, between one company and its trading partners, between employers and employees, and between producers and consumers.[13] These relationships are an integrated entirety, and together they determine the national solution to the two major issues every economy must confront: how to organize production and how to distribute economic welfare. The pattern of the national solutions reflects the guiding principles underlying the economy. In the Japanese context, at the state level, it involved a policy mix that included balancing payments, the convoy administration practiced by the Ministry of Finance, the Bank of Japan's role in the supply of long-term capital, and MITI's support of competitive oligopolies. At the intermediate level, it involved the main bank system, indirect financing, reciprocal shareholding, and the multidimensional integration of business groups. At the corporate level, it involved a strong growth orientation sustained by the permanent employment system.

In the existing English-language literature, many of these institutions and mechanisms have been studied by others. In this study, my contributions seek to (1) bring these independent analyses of individual institutions together into a general picture and see how they have sustained excessive competition and total employment, the two causal mechanisms that have contributed to both the high growth and the rise of the bubble, and to (2) reexamine those

12 Recent literature on comparative capitalism has emphasized the cross-national variations of economic systems. See Berger and Dore (1997), Hollingsworth and Boyer (1997a), and Kitschelt et al. (1999).

13 Rogers Hollingsworth and Robert Boyer argue that a social system of production contains, on the one hand, the industrial relations system, the system of the training of workers and managers, the internal structure of corporate firms, and the structured relationships among firms in the same industry, and, on the other hand, the firms' relationships with their suppliers and customers, the financial markets of a society, the conceptions of fairness and justice held by capital and labor, the structure of the state and its policies, and a society's idiosyncratic customs and traditions as well as norms, moral principles, rules, laws, and recipes for action (1997b, 2). The term *economic system* as I use it in this book is somewhat narrower, focusing only on those institutions and mechanisms related to production and distribution.