T.C.
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SOSYAL BİLİMLER ENSTİTÜSÜ
İNGİLİZCE İKTİSAT ANABİLİM DALI

THE RISE AND FALL OF JAPAN'S DEVELOPMENTAL INSTITUTIONS

89891

Ph.D THESIS

İBRAHİM ÖZTÜRK

T.C. YÜKSEKÖĞRETİM KURULU
DOKÜMANTASYON MERKEZİ

İSTANBUL, 1999

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İSTANBUL, 1999

THE RISE AND FALL OF JAPAN'S DEVELOPMENTAL INSTITUTIONS

by

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Submitted to the Institute of Social Sciences
in partial fulfillment of the requirements
for the degree of

Doctor of Philosophy
in
Economics

Marmara University

İstanbul, 1999

THE RISE AND FALL OF JAPAN'S DEVELOPMENTAL INSTITUTIONS

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Acknowledgement

I am greatly indebted to my supervisor Professor Doğruel, A. Suut, Marmara University, Department of Economics, for his suggestions, comments, and invaluable assistance during the preparation of this dissertation. I wish to express my gratitude to all academic and staff of the department for their continuos support and motivations.

My special thanks is for The Japan Foundation, the Consulate General of Japan in Turkey for their financial support, my host professor Sakamoto, Tsutomu from Keio University, Department of History and his family, the academic and staff members of the faculty and the International Center of Keio University for the environment they have provided, benevolence, sincerity, and great hospitality.

My last, but not least, thanks should be reserved for my family, whom I have neglected, and even forgotten sometimes under the stressful concentrations during my researches in Japan and Turkey.

ABSTRACT

In this dissertation, the rise and fall of Japan's developmental institutions are analyzed. The main thesis is that Japan's developmental ideology and developmental institutions of the post-war years have strongly fostered the miraculous industrial achievements of Japan. The established hegemonic world system and its institutions, as well as domestic structures, have also supported Japan's system to achieve its main targets. With the radical chances in the external political and economic environment surrounding by the late 1970s, the institutions and the ideology of the "old" system have started to lose their relevance. In explaining the under-achievements of the system, the role of the established interest-seeking coalitions among politicians, bureaucrats, and big business should be given special reference.

Japan's developmental institutions of the post-war period were based on production priorities aiming to achieve fast growth, and in turn to generate sufficient employment and income. It was believed that this target could be achieved through maximum foreign trade performance of the industrial structure. Therefore, Japan's industrial institutions and policies have been increasingly characterized by higher savings, investments, and exports. In order to create the domestic winners and champions in the world league, particularly in the strategically chosen sectors, domestic markets were sheltered from foreign competition and the organization of economic activity was left to the guidance, control and discretion of the triple compromise between bureaucrats, big-business, and politicians. Considering the recent situation, it is getting clearer that it has turned out to be against the interest of the whole society. The system has been increasingly hindered due to its lack of transparency, accountability to the people, and isolation from foreign competition in order to maximize the gains of producers.

Although the need for structural transformations at the systemic level have become evident, particularly after the burst of the bubble economy in the early 1990s, such demands, however, have been strongly resisted by the beneficiaries of the existing system. Two other important reasons for the slow pace of reforms are, first, the existence of potential uncertainties surrounding the coming changes, and therefore Japan still is in the process of trial and error. Second, because of the strong belief in the existing system that has proved its competence and strength in overcoming bottlenecks of the earlier crisis and brought Japan "the number one status".

Although the author of this dissertation expects that Japan's system will converge to the Western style market economies, at least to a certain degree, under the existing "fears" and "hopes", however, it is not possible to make a long term reliable prediction for the future discourse of the system.

ÖZET

Bu çalışmada Japon sanayileşmesini mümkün kılan kurumsal yapıların yükseliş ve çöküşleri ele alınmaktadır. Çalışmada savunulan tez, Japon başarısının mimarı olan "kalkınmacı modelin" şimdi bizatihi problemin kaynağı haline geldiği şeklinde özetlenebilir. Japon kalkınmacılık ideolojisi ve bu ideolojiye uygun kurumlar sayesinde Japonya, 1970'li yılların sonuna kadar hızlı bir iktisadi büyüme, istihdam ve gelir performansı göstermiştir. Sanayileşme sürecinde "önde gidenleri yakalama" şeklindeki belirgin bir hedefin olduğu, bu hedefin yakalanması için içerideki kurumsal yapılar kadar uluslararası sistemin de elverişli olduğu bir süreçte, kalkınmacı model hedeflerini elde edebilmiştir.

Üretim öncelikli iktisadi ve toplumsal örgütlenmenin başarılı olabilmesi için sistem mümkün olduğu ölçüde dış rekabetten yalıtılmış, sistemin geleceği de neredeyse büyük sermaye-bürokrasi-siyasetçi arasında kurulan mutabakata dayananmıştır. Bu şekliyle sistem sadece dış rekabetten değil, aynı zamanda içeride şeffaflıktan, halkın denetim ve iştirakinden yalıtılmıştır. Sözkonusu mutabakatın zaman içerisinde sistemi denetleyenlerin kendi aralarında kurmuş oldukları çıkar birlikteliğine dönüştüğü anlaşılmaktadır.

1970'li yılların sonu itibariyle, Japon sistemini mümkün kilan iç ve özellikle de dış değişkenlerin geçerliliğini kaybetmesine rağmen, sistemi denetleyenlerin bu değişimi algılayamadığı ve/veya buna direndiği anlaşılmaktadır. Bu direnişin arkasında kurulu ahbap-çavuş ilişkilerinin etkili olduğu bilinmektedir. Belki bundan daha önemlisi ise şudur: Japonya artık diğer gelişmiş ülkeler ile olan gelişmişlik farkını kapattığından artık kolayca taklid edilebilecek öncü örnekler kalmamış, Japonya için artık bir "deneme-yanılma" süreci başlamıştır. Bu nedenle değişimin Japon kalkınmacılığının öncülleri açısından getireceği belirsizliklerden çekinilmesinin payı çok büyüktür. Son olarak da, geçmiş sistemin başarının yarattığı illüzyon nedeniyle, önceki dönemlerdeki krizlerin aşılmasında rüştünü ispat etmiş modele olan güven devam etmekte, bu modelin artık geçerliliğini kaybettiğinin anlaşılması için de yaşanan krizin biraz daha derinleşmesi gerekmektedir.

Sonuç olarak bir yandan kriz sürerken bir yandan da ilgili reformlar yapılmaktadır. Bu sürecin sonunda Japon sisteminin saf piyasa modelinin savunucularının beklediği gibi Batı'lı piyasa mıodellerine tam bir "yakınsama" ya mı, yoksa kapitalizmin yine Japonya'nın kendine has bir yorumuna mı götürecegi konusu mevcut belirsizlik ortamında tahmin edilmesi güç bir sorundur. Yazarın kişisel beklentisi ise Japon sistemin belirgin bir "yakınsama" sürecinin akıntısına kapıldığı şeklindedir.

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I-INTRODUCTION AND OVERVIEW

Japan's emergence as an industrial powerhouse poses a significant challenge to the standard economic treatment and thus has struck the close attention of scholars from almost every sub-discipline of the social sciences. Therefore, in its present situation Japan could be seen as a social science laboratory in the context of which some fundamental predispositions of social science theories are tested. This inquiry naturally led to the rise of a "social science industry" in order to explain Japanese economic and social performance. The fact that Japan was able to achieve industrialization with a dearth of natural resources and with relatively little financial assistance from outside has further heightened the interest in its industrialization.

From an economist's perspective, the first thing that attracts attention is the assertion of an autonomous state, particularly in organizing industrial activity with the appropriate institutions for economic development. The function of state has been considered to have significant importance in organizing economic activity, in establishing or re-structuring institutions, in giving long term guidance to firms and in signaling the probable future national priorities in promoting certain domestic sectors, particularly through financial market regulations.

Although economists have become familiar with the growing body of literature devoted to various aspects of Japan's economic achievements, there is still an important research agenda in encapsulating the Japanese model of 'market-friendly' organization of economic activities especially in a more tightly knitted world economic network. Japan achieved rapid economic growth in the decades after World War II. But now that it has accomplished its goal of catching up with the advanced industrial nations of the West, it is not sure where it should head next. As we prepare to enter the twenty-first century, Japan's economy is faced with a new set of challenges. It must respond not only to the global problems of the environment, resources, and population, but also to the globalization of political, economic, and social affairs, which have become all the more complex following the end of the cold war. Japan must also cope with the new round of technological innovations and major changes taking place in industry and society. Of the greatest importance is whether Japan will be able to manage its current economic woes and replace the old institutions of its developmental ideology with the new set of institutions in order to motivate the people around a new incentive mechanism. In this introductory chapter a summary of Japan's post-war achievements,

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and an assessment of the system in its "golden age" until the end of 1970s will be presented.

During the second stage of the modernization process from the late 1920s to the mid-1970s, the most important issue before the Japanese nation was to *catch up* quickly with the advanced countries of the West. This required developing heavy industry and systems of mass production and securing means of distribution and the labor necessary for this purpose. The Japanese-style system that had its beginnings in the 1930s and that took its contemporary form in the postwar rapid-growth years was based on a framework of bureaucratic leadership and accompanied by a Japanese brand of developmentalism, which sought to foster industry. But within this overall framework, the bulk of actual economic activity was left up to individual companies, whose primary goals were their own survival and development.

In case of any attempt to encapsulate the Japanese-style market economy in a single set of phrases, it can be said that, first, it consists the use of developmental policies and systems as the medium for a calibrated combination of centralized control and direction by a vertically divided bureaucracy seeking planned rationality, decentralized, and autonomous activities by private-sector corporations, particularly those in high-productivity sectors.

In *chapter three,* the role of institutions in the development process and the borderline between market as "instituted process" and the non-market institutions such state and business organizations, we have noted a set of historical records, which reveals the fact that markets alone are necessary but not the sufficient device for economic development. Without other extra-market institutions, neoclassical conceptualization of a market would be a theoretical abstraction and a chimera. Growth and industrialization is a process, which necessitates relevant institutions at the right time and right place.

In *chapter four*, a detailed analysis of Japan's systemic features in terms of developmentalism has been provided. The definition of term refers to a set of national policy principles and organizational arrangements under which development of industry and fair sharing of its material consequences are seen to be national objectives toward which the entire country should devote its efforts, with top priority given to policies and systems that will be useful for this purpose. Concerning post-war developments, as industrialized economies of the world progress into the service sector maintaining growth becomes an important issue and requires new sets of institutions. For instance, in order for markets to work efficiently, there needed to be modern financial institutions

that could bring together the suppliers and the demanders of goods, foreign exchange and investment. However, Japan, at its earliest stage of development, didn't have such a system in place. Therefore, the bureaucrats did not want to leave to the market's whim what they could control. They wanted to force the scarce resources to targeted industries with high growth potential. That is, neither the institutions of a market, nor the required basic sources of a sound economy existed in Japan at that time. Having considered these constraints a combination of industrial policies had been instituted. One element of this developmentalist policy is to limit competition and to have industry members coordinate their activities to avoid dropouts.

Discussions in *chapter five* highlight that around 1940, with the aim of putting the economy on a planned wartime footing, measures were adopted limiting shareholders' interests and replacing direct with indirect financing; all citizens and all industries were placed under state control. After Japan was defeated in the war, democratic reforms were implemented, and the objective of economic policy shifted the implementation of wartime controls to the pursuit of rapid growth. With this change, the economic arrangements were modified in various ways to match changes in the surrounding conditions. The basic framework, however, remained more or less the same as immediately before and during the war, up until the 1970s.

During the Occupation by the U.S., there was a law passed called the 1949 Foreign Exchange Law. Because most of Japan's industries had been converted to military manufacturing, many of them were destroyed in the war. With little base for exporting, and a great need to import raw materials, food and other supplies, Japan had little foreign exchange to spare. So, this law strictly controlled the allocation of foreign exchange and limited its use on food, and other raw materials. As Japan regained its sovereignty in 1953, the Ministry of International Trade and Industry (MITI) used this law as the basis for Japan's industrial policy.

Industrial policies focused on the implementation of government regulations on trade, investments, and subsidies. There were many reasons for these regulations. One reason was to close the gap between the domestic production price and the world price. Protection would help infant industries with potential to achieve economies of scale. The intra-industry ripple effect of growth would cause instant hikes in productivity. Lastly, these growth industries had a large emerging world demand. In the 1950's before any type of economies of scale was realized production costs were very high. In order to sell cheaply, producers needed to get big and *vice versa*. Under the circumstances of

free trade, cheap imports were beating out domestic goods. In three years, imports of European cars grew by 15%. Output of these European companies was 6 times that of Japan. So, Japan had to implement some type of protective structure to aid the infant industries.

Subsidies were used and were effective in trying to lower overall input costs to production. In that sense, subsidies were sort of an import barrier because subsidies benefit the home industry artificially keeping prices high. However, it is the case that consumers and taxpayers end up paying for this subsidy twice, through taxes and higher prices. In the machine tool industry, 50 per cent of the purchase price from domestic industries were subsidized. In other areas, loans were subsidized as well. Government officials would grant loans to specific industries at interest rates 1-2 per cent lower than market rates.

Tax breaks were another method of protection. Currently, Japan has one of the highest tax structures for corporations, ranging about 6 percent above most western nations. Temporary tax cuts were mainly used to encourage companies to export their goods. In the steel industry in the 1950's, a 25 per cent tax cut on export profits was implemented.

One of the biggest regulations that were implemented was the law against importing goods. As outlined earlier, foreign exchange was in high demand those first few years after the occupation. MITI took control of the foreign exchange and wouldn't allow imports of a product that competed with a protected industry, no matter if the import was cheaper. There were also strict controls on foreign direct investment. There could be no wholly owned foreign subsidiary located in Japan. In order for a transfer of technology to occur, a corporation, such as IBM had to enter into a joint venture with an existing Japanese firm and even then it could not be a majority party. Japanese business was strongly encouraged to only license the technology from foreign firms and then learn how to duplicate it.

As Japan's exports grew, foreign exchange was no longer a scarce commodity. It soon joined GATT (The General Agreement on Tariffs and Trade) which forced Japan to agree to end direct government impediments to trade. As quotas fell, however, tariffs rose. The overall general rate of protection was as high as 22-30 per cent by 1978.

The private sector also created impediments to trade. Because of the high rate of protection, firms in the heavily protected industries held oligopolistic power. These industries were dominated by *keiretsu* (business conglomerate groups). Each keiretsu

had a major bank as its financing center, and each company within the group held a percentage of every other company's stock. Because this was encouraged by MITI, the overall percentage of cross-share holding increased from 42 per cent in 1964 to 62 per cent in 1973. This effectively kept foreign companies from entering into the Japanese market via FDI. Within these keiretsu groups, protection is offered when economic times are bad. Banks will bail out failing companies to keep them afloat. Because of the cross share holding it is in the best interest for all companies within the group to keep everyone healthy. At times this is costly, which leads to overall decreased profits relative to non- keiretsu companies. However, the lower profits act as an insurance premium in economic downturns. These ties act as a deterrent to imports because if an auto producer is buying from an auto parts supplier within his own keiretsu, this is only strengthening his stock. He wouldn't go outside of the keiretsu group for fear of banishment from the group. That is why Japanese producers will buy from other Japanese input producers and not purchase cheaper imports.

Exports are looked upon as the way to increase profits as well as generating income and employment for the citizens. The income and employment generating effect of foreign trade was considered as one of the most important criteria for success from the viewpoint of developmental ideology. In order to export, however, there are some important requirements. One of those requirements is the economies of scale. Because of increased home protection and a redistribution of wealth through taxes and high prices, an emerging middle class was able to supply enough demand to boost output. Because greater economies of scale were realized and production surpassed domestic demand, export performance also soured.

The mix of exports in Japan shifted very rapidly in a matter of 20 years. In 1971, 33 per cent of exports were not part of the export base 10 years earlier. Almost 40 per cent of exported goods didn't even exist in the Japanese market 20 years previous. And in 1969, 10 per cent of output consisted of goods that hadn't been invented in 5 years earlier. In the early 70's the biggest exporters were the auto, ship and steel industries. They accounted for 40 per cent of all exports. As domestic demand leveled in the late 70's and early 80's in each industry, exports continued to fuel the growth. In the ship building industry, only 3,000,000 tons of ships were demanded domestically, whereas 16,000,000 tons of ships were demanded abroad. This was a complete reversal from only twenty years earlier.

The export business was enhanced with a cartelization law called the 1953 Export/Import Trading Act. This allowed, on average, 900 cartels per year, 200 of which were export cartels. They fixed domestic prices high and kept a minimum export price to avoid price wars with other Japanese firms. They limited imports and planned on how to carve up the export markets.

One important feature of the policy-making process in Japan has been that, at least until the 1970s, the bureaucracy was entrusted not just with the task of administering policy but also with the role of drawing up policy proposals. Facilitating this was the preservation of the prewar bureaucratic machinery even after Japan's defeat. Although the U.S. Occupation Forces oversaw the dismantling of the army and navy, it elected to retain the administrative system in order to rule Japan indirectly, and thus controls based on licensing and authoritarian systems and so-called administrative guidance continued to operate.

Unlike the American system where bureaucrats are appointed, under Japan's system of parliamentary democracy, by contrast, there is no infusion of new officials with the start of a new administration. In Japan, however, there are several forums and institutions that mediate between the public and private sectors, facilitate the exchange of opinions and suggestions. A third difference is that the relationship between the bureaucracy and the private sector has been a pragmatic one. Bureaucrats have not simply implemented laws and regulations but have used their discretionary authority to build agreements with the industries they regulate, conducting unofficial contacts grounded in mutual trust before coming out with official decisions. In recent years efforts have been made to see that bureaucratic authority is used in a less arbitrary and more transparent fashion with such steps as the passage in 1993 of the Administrative Procedure Law. But at least until the early 1980s, even the private sector inclined to see administrative guidance in a positive light.

Noting the established symbiosis between private industry and the bureaucracy, some observers came to refer to the country as "Japan Inc.," implying that the entire economy was functioning like a single corporation. But it is not true that every industry submitted to a single overall management scheme directed by the bureaucracy such as MITI or Ministry of Finance (MOF). The economy of this period was not one where free competition held full sway, but at least within such highly productive industries as household appliances and automobiles, the rivalry was indeed fierce. The intense jousting among companies within the growing domestic market during Japan's high-

growth years should certainly be noted as one of the factors that helped make Japanese manufacturers strong contenders when they entered the international marketplace.

The less productive sectors, meanwhile, were subjected to a relatively high degree of regulation. This category includes such state-operated enterprises as the postal service and the national railways (later privatized), industries like transportation and energy, whose activities were based on specific legislative mandates, and small-scale businesses like farms and retail shops. The government used a very heavy hand in protecting and fostering these businesses, setting controls on entry and pricing, as well as offering subsidies and tax breaks. As a result, the inefficient firms in these sectors managed to survive. One reason for preserving these inefficient sectors, which has deep repercussions on the current crisis was that until the 1970s Japan suffered a chronic shortage of foreign currency. This made it difficult to pay for imported manufactured products other than the machinery and raw materials needed to manufacture tradable goods, and so it was deemed necessary to maintain a full complement of domestic industries in every field. This strategic choice is consistent with and the necessary outcome of Japan's developmental ideology.

The second important dimension of developmentalism is the emergence of Japan's famous corporate structure. By the late 1960s, Japanese firms started taking their places among the top largest of the world. What were their dominant features, which brought them this world class championship? Are there any relationship between their drive for world-wide market share capture and the current systemic malfunctioning? As it will be presented in chapter six, most Japanese enterprises are legally incorporated, generally, in the form of joint-stock corporations. But their principal objective has been their own survival and prosperity - in particular, the enhancement of their corporate status. This status was determined by two criteria: the standing of their industry as a whole relative to other industries in terms of prestige (as referred to in the once-common formulation "Steel is the nation") and the position of the company itself within its industry in terms of historical status and market share.

Management came to concern itself above all with employees, who were the source of the technological and development strengths and the production and sales abilities that determined the company's performance. Every year companies, particularly major corporations, hired new graduates to incorporate them to internal or in-house labor markets. The new recruits, like other permanent employees, would be subject to rotation at periodic intervals, and through this process they would be trained as all-

round members of the corporate team. Under this arrangement, moving to other companies and the hiring of people with previous employment experience were the exception.

With steady, long-term employment and seniority-based pay and promotions the norm, workers tended to develop a strong sense of loyalty to their companies and to see its fortunes as being their own. The downside of this "companyism" was that it tended to make the company closed, with relatively little involvement between those on the inside and the local community or others on the outside. The term *shain*, or "company members," originally referred to stockholders, but as ownership and management grew apart and corporate management functions came to be performed exclusively by executives and employees (the executives themselves generally having risen through the corporate ranks), the word came to refer to the employees. This was a reflection of the overall lowering of the significance of stockholders that accompanied the shift from the prewar system of direct financing (i.e., through equity issues) to a system of indirect financing, mainly through borrowing from banks.

It has been also shown in chapter six that use of corporate surplus during the 1970s, and government's expansionary deficit financing method constituted the infrastructure of bubble phenomenon in the economy, which has been discussed in *chapter seven*. After the burst of the bubble economy, Japan's severe recession and prolonged structural crises started. In order to reform the economy a set of reformation packages have been implemented without major results appearing until the end of 1998, which ended by around three per cent real contraction.

In the *final* chapter, concluding observations and policy implications of this dissertation on the rise and the fall of Japan's developmental institution will take place. Accordingly, the social cost of Japan's industrialization and some useful preventive measures for the coming reformation period are also noted, as the lessons were derived from the Japanese case.

II. EXPLAINING JAPAN: Discussions on the Nature "the Japanese Model"

According to the Bank of Japan's statistics, at the end of 1989, Japan's gross national product (GNP) exceeded $ 2.5 trillion. This accounted for twelve percent of world GNP; its per capita GNP of $23.000 exceeded that of the United States; it was the world's largest creditor nation, with external assets of $300 billion; and Japan also became the world's largest donor, providing $9 billion in development assistance. 1990 also marked one of the most long-lasting economic expansions of 47 consecutive month, with five- percent growth and basic price stability. Ozaki's interpretation of this situation was as follows:

> "The current boom as well as past performance show that Japan's economy is highly dynamic and efficient promoting technological progress and restructuring smoothly without leaving behind pockets of unemployed in depressed industries. The main source of dynamic efficiency is the enterprise system that has evolved in postwar Japan, though this system is neither sufficiently recognized nor well understood by outsiders. Like the United States, Japan has a competitive market economy, but the way it works differs considerably from the workings of the United States economy" (Ozaki, 1991, 172).

Japan's historical account of economic growth (table2.1), the euphoria about past growth is yielding to concerns about the future. A social science industry has emerged in order to explain the Japanese case ranging from Kahn's Emerging Japanese Super State (1970), Vogel's Japan as Number One (1979), Mourdoukoutas's Japan's Turn (1993) to Emmot's The Sun Also Sets (1989), Dattel's The Sun That Never Rose (1994), Reading's Japan's Coming Collapse (1992), and Kat'z Japan: the System That Soured (1998). In this chapter, a short overview of discussions on Japan will be provided.

Table 2.1- Real GDP Growth, (Japan and the United States, annual percentage)

Sub-period	Japan	United States
1890-1905	2.65	3.86
1905-1920	3.49	2.85
1920-1935	3.18	1.39
1946-1960	9.38	3.45
1960-1975	8.24	3.81
1975-1990	4.12	2.96
1990-1997	2.26	2.77

Source Ito (1996, 209) and OECD Economic Outlook (1998)

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Before going into the detailed discussions on the nature of the Japanese system, a short historical perspective on its evolution is provided below.

2.1- Historical Settings

2.1.1-Infrastructure of Economic Development During Tokugawa Period

During the Tokugawa period (1600-1868), due to more than two hundred years of domestic peace not only had feudal class differentiation begun to lose its originally-expected function but also the relevant setting for modernization in the country was established. *First*, old warrior *samurais* left their provinces, engaged in bureaucracy as a sort of civil servant. *Second*, even in the period of isolation Japan had encounters with the Western countries in the port of Nagasaki. In this city, the Dutch and the Chinese were allowed to trade with Japan for more than two hundred years, and thus Japanese understood well the necessity of Western learning even before the deep changes in international politics of the Far East brought by the Opium War between Britain and China in 1838 when Japan paid the first official attention. *Third*, in the period of isolation national *harmony* increased, and a *homogenous* nation state emerged. Basic societal values such as *conservatism*, *loyaltism*, and *subordination* were created with public good characteristics which proves to be an important prerequisite for a successful and sustainable modernization and capitalist mode of development (Smith, T.C., 1961).

What is striking here is that, among the major legacies of the Tokugawa were non-economic factors ranging from widespread education in schools for commerce (*terakoya*) and a literacy rate of some 40 percent, a pool of able and dedicated administrators, many from the samurai of *Satsuma* and *Choshu*. And most importantly social and cultural attitudes and values were illuminated in a wash of literature on Japanese society (Mahcperson, 1994).

On the surface, Japan in 1868 appeared to have a relatively backward economy. It was still heavily agricultural with approximately 80 percent of the gainfully occupied population engaged in farming. This, however, was no ordinary backward economy due to the efforts made during the Tokugawa Period. Strong evidences point to economic

change and development occuring in the Tokugawa period. Agriculture, for instance, in many parts of the country was drawn into a well-developed system of national markets that encouraged specialization and stimulated productivity. Moreover, a good number of farm families were engaged in part-time non-agricultural occupations. A variety of cottage industries developed, such as brewing, ceramics, paper, food processing, mining, metals, and woodworking. As a consequence, many kinds of commercial and handicraft skills were widespread among Japanese farm families. The growth of the cottage industries reflected the rise and spread of attitudes conducive to economic change and development. In other words, probably the latest resource that the Japanese economy had as it began its period of growth was a well educated, economically motivated, and highly disciplined population. The growth of traditional manufactures in the late Tokugawa Period had tutored this population in specific skills, attitudes, and commercial practices, which made it highly responsive to further economic development (Rosovsky, 1994, 231).

2.1.2-The First Industrial Revolution and New Challenges to the "Periphery"

In those years, in the west, widespread effects of the first Industrial Revolution became visible and "late comers" or the "newly industrialized countries" such as France, Germany and the United States of America were catching up to Great Britain, the creator of the first Industrial Revolution. Britain was trying to keep its advantage of being the forerunner of industrialized society. Under the supervision of Great Britain, an international economic order (British hegemonic peace and stability) was created for freer trade and as a result world trade expanded tremendously both in terms of volume and value.

In these years there was a newly emerging resistance to the expansion of worldwide imperialism within and outside of Europe. In the same way, these continuous confrontation were reflected among the intellectuals, scientists and state officials on the nature of relevant economic policy for promoting industrialization. According to the ideas of Frederick List, Germany was pursuing a highly active "industrial policy" and thus there was a protectionism on behalf of "infant industries" within the country. Most of the arguments emphasized that Smithian ideal of the "invisible hand", though a desired future outcome, does not reflect real world economics. The reason is that because a totally liberal economic order would only

contribute to the interests of the industrialized countries such as Great Britain, whereas developing countries, particularly those in industrial transition towards more sophisticated stages, were forced to retain a traditional agricultural economy. This would mean the perpetuation of economic dependency of the periphery.

The 1838 trade concessions of the Ottoman state to the major Western countries and the 1854 Japanese agreement with America in opening its major ports to foreign trade showed that major "periphery" countries were forced to be integrated passively to the world trading order lead by "the center" countries. The term "passive integration" is used here to imply import dependency of developing countries with huge amounts of trade deficit and high debt burden.

After the first Industrial Revolution, European countries shifted to a more sophisticated pace of industrial development with mass production and improved services. Mass production required that large and overseas markets should be open to these recent manufactures of the industrial age. On the other hand, as a result of a deep social transformation of village communities towards large metropolitan cities, a massive urbanization emerged. This means that old structures lost their weights and a new societal scheme was created on the basis of new class confrontations among employees who relied on labor income. With the emergence of this class confrontation around "surplus value", the economic problem was concentrated around not only production, but also distribution and allocation which do not necessarily reconcile at any given time, particularly when measured in terms of efficiency and equity (Clough, 1968, 176).

2.1.3-Early Encounters With the "Modernizing" West and Japan's Response

In addition to the progresses during the Tokugawa period, Meiji Restoration in 1868 took one final step towards modernization.. Just before the overthrow of the Tokugawa order, however, in 1844, King William II of Holland dispatched a letter to the Shogun of Japan warning him that the quickening pace of world events would make continuance of the Japanese policy of national seclusion both unwise and untenable. The development of steam navigation, for one thing, now enabled the ships of the Western countries readily to penetrate the most distant waters of the world. Therefore, Japan could not expect to remain aloof from world affairs much longer.

Facing the overwhelming military superiority of the West, treaties were signed with Western countries and trade resumed in the period 1853-1858. In the immediate aftermath of messages from the Western countries, the agenda both among the leading élites and intellectuals concentrated on what extent the country should be open to the foreigners. In 1854, the U.S. fleet or the "black ships" anchored off Uraga, a port near the capital Edo (Tokyo) under the command of Commodore M. C. Perry. Japan was forced to abandon seclusion policies, which had lasted for two hundred years. Perry achieved the first objective through the signing of the *Treaty of Friendship (1854).*

According to this "unequal treaty" (or enforced concessions) Japan would open its two ports to American ships permitting a certain amount of closely regulated trade. An American consul was also permitted to reside at Shimada, and it was stipulated that any new concession granted to other Western countries would automatically apply to the United States as well. This provided for an exchange of consular officials between Japan and the United States. America's main mission was opening diplomatic and commercial relations with Japan. Eventually, in 1858 this treaty was reviewed and extended (Varley, 1973, 160).

Although Meiji and his friends were in strong opposition to the concessions and submission of the old regime to the West, considering the severe constraints and other practical reasons, they decided and voted for "non-confrontation" policies. Japan's "modernization" from the Meiji period until the present may be divided into three stages. The most important sign of the way and the direction of the new regime can be observed from the Charter Oath, the outline of the modernization:

- Article 1. An assembly shall be established and all matters of state shall be decided by public discussion
- Article 2. All classes high and low shall unite in vigorously promoting the economy and welfare of the nation.
- Article 3. All civil and military officials and the common people as well shall be allowed to full-fill their aspirations, so that there may be no discontent among them.
- Article 4. Evil customs of the past shall be broken off and everything based upon the just laws of Nature

Article 5. Knowledge shall be sought throughout the world so as to strengthen the foundations of imperial rule" (Beasley, 1972, 323).

The first period of modernization, the period from the 1860s, the final years of the Tokugawa, until around World War I, centered on the Meiji era (1868-1912),and was a time of westernisation, with emphasis on taking Western Europe's intellectual and material offerings. The approach that took hold sought to mix the introduction of Western civilization with the preservation of Japan's traditional spirit. There was a broad consensus about the direction in which the nation should head, namely, away from Asia and toward Europe, the goal being to turn Japan quickly into an "enlightened" country that could join the ranks of the Western powers. The Japanese of the time, observing Western Europe's incursions into neighboring Asian countries, saw this as the only way of avoiding the fate of colonization of their own country. To achieve this basic goal, the Meiji government carried out sweeping social reforms, accompanied by a drive to foster industry, enrich the country, and strengthen the military (Burks, 1983). The Meji government founded state-owned enterprises, which they regarded as important from the viewpoint of "nation building". Since government had been founded by intelligentsia, who had awakened to an awareness of the new era, management of the state-operated enterprises were also in the hands of the same sort of people (Jansen, 1983, 11).

Japan's imports from the West during this period included *its economic systems and industrial and management structures*. Major pillars of the resulting set-up included the joint-stock company, stockholder control of corporate affairs, direct finance, and adjustments of staffing levels in the pursuit of profits. To summarize, the new government was decisive in establishing a modern state in line with Western countries and with this aim the following measures were taken just in the immediate aftermath of the Meiji revolution.

First, in order to establish the infrastructure of industrialization in many fields, it *unified the administration* of the country under a single roof or authority. Any kind of feudal restrictive regulations concerning population immigration such as taxes and passports; mobility of goods and services were removed and thus a well developed unified national market was created. For instance, the sale and disposal of land was made legal, thus giving formal recognition to a practice that had for a long time existed in one form or another. The landowners were made responsible for payment of the tax and land titles were issued to them. Furthermore, by creating a national army, the central authority was reinforced and thus local powers were taken under control. International trade barriers were also lifted and export of, for instance, rice, wheat,

copper, and raw silk was promoted. Although responsibility for administration was returned formally to the Emperor Meiji, in practice young leaders were clearly in command.

Second, government also played a critical role in providing prerequisites to economic growth by creating an infrastructure of communications, public utilities, a modern, wide-scale and compulsory education system, and financial services. Moving very resolutely and effectively in these fields, the government by the 1880s had succeeded in linking nearly all of the major cities by telegraph. In the same way, by the end of the century, nearly 5,000 miles of railroad had been laid. More important than this is that, in undertaking all these railroad construction activities, Japan gained all the required technology and know-how of the transportation industry.

Equally important is the contribution of government in the field of currency and banking for the soundness of the future economic growth such as the adoption of a new and standardized currency, and the establishment, in 1872, of a modern banking system with the issuance of the National Bank Act. This newly established banking system depended heavily upon capital supplied by the *Samurai* commutation bonds. The role of the government in controlling one of the most serious problems of inflation in the history of Japan was equally important. By the turn of 1885 the main targets of government were achieved: the central bank was functioning, currency, purged of inconvertible paper, had become respectable and revenues were consistent with expenditures.

Third, old feudal domains were abolished. Reforming the existing class structure, the privileged position of the *Samurai* class was eliminated. They were motivated to take place in the formation of new a bureaucracy as the new sources of prestige and national pride in the way of creating *fukoku-kyohei*, or if they wished they were supported to concentrate their Samurai spirit toward commercial activities and other fields requiring strong entrepreneurial capability. These were introduced to promulgate the new version of strong patriotism.

Fourth, land tax reform was realized successfully. This was critical because agriculture continued for many decades to be the chief source of national revenue, particularly in the take off period of industrialization. This is due to the fact that because all of the reforms necessary for modern economic growth, the government had to have substantial income and, for much of the Meiji Period, the land tax was the primary source. It was therefore vital that the determination and collection of this tax be

modernized. During the *Tokugawa* Period the land tax had been collected nearly everywhere in *kind, as a fixed percentage of the annual* harvest. Since the amount of tax revenue collected by the government each year depended on the quality of the harvest which can not be controlled or predicted, this important source of revenue was open to the seasonal fluctuations caused by changes in the market price of rice. This, in turn eliminates the viability of the required modern planning and budgetary process that eventually hinders economic modernization. Therefore, to do away with the annual fluctuation in tax revenue dependent on the amount of harvest, the new tax was assessed according to the value of the land. The net effect of these reforms, therefore, was to establish a standard tax that would be paid in cash, thus providing the government with a known amount of revenue.

In addition, without raising their average tax burden, the reforms encouraged farm owners to increase their capital investment and rationalization of agriculture (better implement seed selection, and fertilizers, and increased drainage and irrigation), thereby contributing to a steadily increasing agricultural activity during the Meiji Period. Because Japan was still predominantly rural and agrarian with the farm sector accounting for 70 percent of employment, half the gross domestic product, and three quarters of all tax revenue, the land tax reform was a major achievement.

> "Land reform, because it succeeded in solidifying the social foundations of the new government and in stabilizing its principal source of income, the land tax reform is regarded by some scholars as the single most important reform of the Meiji Restoration" (Johnson, 1992, 107.)

A significant point to note is that these were all in line with the Anglo-Saxon style of management. A distinctive Japanese system had, at that point, yet to evolve (Jansen, 1983), and therefore, the industrial structures of Japan and the West were more similar in 1910 than they were in 1970. With its success in modernizing both its military and its industry, Japan by the end of World War I ranked as one of the world 's significant powers, and in the field of light manufacturing it had developed a more or less full-fledged set of capitalist institutions. As a result of her modernization process, by the end of 19th century Japan ranked among the foremost powers of the world in equal standing with the West.

2.1.4-Debate on the Role of Pioneers for Industrialization: The Schools of Growth From Above *versus* Growth From Below

Describing the initial take-off phase of the Japanese capitalism, the role of the state is discussed under two headings: The Growth From Above School (GFA) and The Growth From Below School (GFB). The GFA School argues on behalf of a government role and small group cooperation with the state during the early period of industrialization. The main thesis of this school is consistent with Gerschenkron's argument on behalf of the government in the early phase of development. Analyzing mainly German and Russian process of industrialization, he concluded that the more backward the economy, the greater the reliance on the state rather than on private enterprise is required (Gerschenkron, 1965).

More specifically, adherents of the GFA school stress the importance of the establishment of national banks, the government's role in importing technicians, sending students abroad, and investing in the industrial sector. In particular, they point to the role of official entrepreneurship in the establishment of model factories.

Construction of modern cotton mills and the purchase of British spinning machinery by the government in the early Meiji Period set an example for private enterprise. These two acts overcame the initial ignorance of machine technology and factory organization. Then, once private inertia was overcome, these "model plants'; were sold to private industry at low prices and on easy terms. Smith writes that without government help private capital would have been no more successful in developing machine cotton spinning in the decade after 1880 than it had been in the decade before (Smith, 1961).

The years from 1868 to 1885 were critical because Japan mobilized its material and human resources and laid the foundations for modern economic growth. The great-unsettled issue in the study of this period is that of determining the prime force behind the drive to industrialize. The part that government played in mediating the industrialization of Japanese society has been the subject of much discussion and controversy. There has been a tendency to credit the state with a larger role than it actually played in the process. The main theme here is that private enterprise activity of the individual Japanese played no less a critical role than the state. What the government did was to provide the setting for industrialization, destroy old institutions that had proved obstacles to an industrial society, and create in their place new ones that

would facilitate industrialization. It created the "infra-structure" of communication and financial institutions that was essential to the efforts of private entrepreneurs.

Initially, the most important contribution of the state was that the new Meiji leaders set economic growth and achievement of industrial strength as national goals. This decision was not something that emerged suddenly in 1868 but was, rather, the outcome of a long development in the late Tokugawa period. Adherents of the path-dependent paradigm believed that government must itself adopt a policy of encouraging industry and commerce as a means of solving its own economic problems and of increasing its own strength. That policy gained support in the country by the end of he Tokugawa Period and the new leaders of the national government after 1868 effectively implemented it.

To explain the motivation behind the drive to industrialize, many adherents of the GFA School emphasize the patriotism and samurai spirit of the Meiji leaders and of the entrepreneurs who were closely associated with them. They argue that the traditional merchant class of the Tokugawa Period was largely lacking in the quality of opportunism, inventiveness, and risk-taking that ordinarily characterize modern entrepreneurship.

Instead, they find motivation arising out of the nationalistic or community-centered spirit of the old samurai class. As a result of their training, the samurai, in this view, possessed a selfless dedication to the nation that moved them to work for a wealthy powerful country able to ward off the Western imperialism. That is, the feudalistic samurai or their sons shouldered the leadership role of the Meiji entrepreneurs. The development of capitalism was guided by bureaucrats who were samurai and by business leaders who were also of samurai origin. Thus the Meiji entrepreneurs were strongly motivated by the semi-feudal spirit of *shikon shoosai* (the soul of the samurai with business acumen) (Smith, 1961).

Why did Japan alone among the non-western countries make a rapid transition to industrial society? The answer, for the GFA School, lies in the "unique cultural heritage of strong leadership". The spirit of *bushido*- the warrior code- inspired elements of the samurai class to selfless devotion to their nation, led others to invest their commutation bonds in the new national banks, and so fueled Japan's industrialization. In other words, the GFA scholars stress a unique motivation behind Japanese industrialization- an irrational, non-capitalist, dynamic and romantic approach of the pioneering entrepreneurs.

On the other hand, the GFB argues that the traditional interpretation "overemphasizes the contribution of government and large-scale enterprise to increase in output. Proper emphasis should also be placed on the contribution of the myriad of smaller rural and urban entrepreneurs who used more labor-intensive methods of production that embodied relatively simple improvements in technology, who acted in response to opportunities for profit, and who were relatively independent of the government. These critics point out that the model factories were losing money when the government sold them off in the early 1880s and that afterward, in the hands of private managers, they earned substantial profits. The conclusion drawn, therefore, is that private enterprise was not incapable of successfully developing modern industries.

As a consequence of their emphasis upon the role of the commoner class, adherents of the GFB School emphasize the profit motive rather than the peculiar patriotism of the samurai class. Many of the Meiji entrepreneurs emerged from the *gorto*, the wealthy peasant class in the villages. The experience of their families had done *much* to prepare them for this new capitalistic undertaking. In the first place, they sprang from a tradition of leadership acquired in the villages, where many of their fathers had served as village headmen. Second, they had accumulated capital through investment in rural enterprises. Third, the experience in undertaking rural enterprises gave them qualities of initiative, self-reliance, and risk-taking that the traditional city merchants in the Tokugawa Period had long since lost. Fourth, these commoners were rendered both ambitious and frustrated by their position in the Tokugawa class structure. During the late Tokugawa Period, they had been able to share in the attributes the Samurai class-occasionally buying the right to wear swords, their sons to fief schools, and take surnames. Yet they were not treated like the real samurai, and this experience frustrated them. They were therefore anxious to rise in the world, to do better than their fathers. Fifth, as a group the wealthy peasantry had always placed a value on education and hard work, the interest in education, coupled with the wherewithal to acquire it contributed powerfully to emergence of young landlords' sons in the business elite.

An excellent example of this phenomenon is a man named Shibusawa who rose from peasant origins to become the founder of Japan's impressive modern companies. His father was a village headmen and rural entrepreneur who had invested widely in village industries. Like many wealthy farmers' sons, Shibusawa received a samurai education. Eichi entered the services of the Tokugawa family and in this capacity ac-

companied a Tokugawa prince to France in 1867. When he returned later, having the extensive knowledge of the West that he did he was able to enter the new Ministry of Finance in a prominent position. He resigned from the ministry in 1872 in order to enter banking and shortly became president of the First National Bank. His mastery in the field of banking led him ultimately into connections with more than 500 diverse industrial enterprises as a president, a director, or a major shareholder. One of Shibusawa's impressive early entrepreneurial achievements was in the field of cotton spinning. He imported the latest technology and in 1880s directed the construction of the Osaka spinning mill, which, owing to its up-date technology and efficient organization, proved extremely profitable. It became a model for the development of other successful textile ventures in Japan.

However, the debate between these two schools is ultimately resolved. We may conclude that the government played an important role in creating the environment within which growth could take place. Establishing a unified national administration, mobilizing human resources, and skillfully using fiscal policy were essential contributions of the state. Moreover, through what is now called "administrative guidance" (that is, through guarantees, subsidies, and preferential access to bank funds), the government used its influence to encourage economic growth. On the other hand, a new breed of entrepreneurs was clearly emerging in the private sector, and their ambition, inventiveness, and opportunism contributed immensely to the expansion of commerce and industry in this period. That is the GFA and the GFB proceeded together.

2.2-Foreign Learning and the Nation State as a Unit of Analysis in Development

In this section, it will be argued that neither the school of growth from above, nor the school of growth from below is sufficient to explain what really happened in the early phase of modernization in Japan. Despite the changing weights of each school along this period, it should be underlined that there were two way mutual reinforcing interactions among them. Considering the foreign influence and the common perception of this influence by private and public spheres, they cooperated in creating the desired path for development.

It should also be underlined at the outset that one of the major impacts of the German Historical School on the intellectual and policy formation of Japanese industrialization agenda could be observed in the context of her drive for

developmentalism along the history of Japan. Also the source of nation as a unit of analysis for modernization could be attributed to the effects of Germany on Japan. In addition to learning a great deal more about the sources of Western industrial and military power, the Meiji leaders who went abroad with Iwakura Mission strongly reconfirmed their views of the predatory nature of international politics. Above all, they came back impressed by the need for national self-reliance. The Iron Chancellor Otto Bismarck of German cautioned them to prepare Japan for intense competition among nation-states. The official narrative of Iwakura Mission records that on Bismark was as follows:

> "Although people say that so called international law safeguards the rights of all countries, the fact is that when large countries pursue their advantage they talk about international law when it suits them, and they force when it does not. Small countries try and try to get a favor decision only to fail sadly; it happens time after time that they can hardly maintain themselves and have to endure insult and aggravation even though they do their best to maintain their sovereignty." (excerpted in Gao, 1997).

Bismarck concluded that everything he had learned convinced them that a nation could preserve its independence only through policies of strength and the cultivation of patriotism among the people. Bismarck's words reinforced what the Meiji leaders had already decided: Japan must rely only on itself. The world Japan entered was of struggle not just for survival but for superiority over other. Two years before the departure of the mission, Iwakura had written in a memorandum on foreign affairs, 'although we have no choice in having intercourse with the countries beyond the seas, in the final analysis those countries are our enemies. Why are they our enemies? Day by day those countries develop their arts and their technologies with a view to growth in wealth and power. Every country tries to become another country's superior. That is why I say all countries beyond the seas are our enemies". The members of the Iwakura Mission returned from the West further convinced of the imperial Japan to become self-sufficient in its economy and in its strength; for that purpose a sharply focused but long-range view of Japan's national interest must be the foundation of a comprehensive plan for Japan's development. The members of the Iwakura mission understood that once the mission returned with conclusions about what was necessary to achieve treaty revision, new policies would then be formulated to guide Japan's future course (Blacker, 1957, 840).

Prior to the departure of the mission, much of the work of political consolidation of the new administrative state structure had been set. The Central government had been

strengthened, the autonomy of the feudal domains largely overcome, and a monolithic bureaucracy established. Moreover, the leaders wholeheartedly agreed that unification of the tax system and the military had to be addressed, that samurai privilege had to be terminated, and that an education policy must be fixed in the service of the state.

Sufficient prior agreement allowed the caretaker government to promulgate a new education law in 1872 and a national conscription law in 1873. But the caretaker government went beyond this and, a major foreign policy decision was made that would have sanctioned a punitive expedition against Korea for its rejection of diplomatic ties with the new Meiji government. This matter of a Korea expedition brought to a head the issue of priorities for the new government and the future path of Japanese imperialism on the Asian Peninsula.

Till the end of 1870s, the dominant nature of state policies in the way of creating *fukoku-kyohei* (enriching the country, strengthening the military), was the general objective of the Meiji Restoration. If *fukoku-kyohei* was to succeed, it was believed that the Meiji government must formulate a clear set of policies and take the lead. This is because Japanese people are particularly lacking in daring: to encourage them to overcome its weakness and to study industry and overcome its difficulties is a responsibility the government must assume. Under the influence of the German Historical School, active state leadership in economic modernization was required because of Japan's position being different (*ibutsu*) from other countries pursuing free trade policies with minimum state involvement in industrial activity. Japan should create some kind of "different laws" for Japan and among these, "the encouragement of industry" (*shokusan kogyo*) by the state should be involved.

The catch-up vision that suffused the motivation of Okubo and the Meiji leaders became over time a national consensus, a goal repeatedly held up as one toward which all Japanese must aspire. The roots of Japanese developmentalism is closely related to the intellectual activities of the late Tokugawa and early Meiji period economists such as Fukuzawa Yukichi, Arisawa Hiromi, Nakayama Ichiri, Tsuru Shigeto. After Emperor Meiji came to the power, studies in economics were supported and several dozens of translations made by the early 1880s. At the beginning, Japanese intellectualism was influenced heavily by the British economic theories, advocating the merits of laissez-faire policies. For this reason, among the initial translations Adam Smith, and Jonh Stuart Mill took the first places.

In the second stage of the Japanese mission to the West, Japanese intellectual

shifted their attention to the German Historical School and the founder of this school, Friedrich List. The Social Party Association (1897) became the representative of the German Historical School in Japan. The declaration of this association stated that, they opposed the laissez-faire capitalism because it relies on extreme selfishness and excessive competition. They declared also that they were against socialism for its antipathy towards existing institutions, and its strong opposition to the capitalist class. They supported private property, but they also believed at the same time that class conflict can be prevented by the cooperation of major classes under the guidance of the state and therefore social harmony could be achieved.

The impact of different schools of thought in economics were perceived in a different way and therefore produced different outcome in Japan. It can be argued that the Japanese economy and intellectual thinking were under the influence of the British until the 1920s. There was also a growing and impressing influence of German managed economy doctrines after the Great Depression, and the influence of soviet type five year planning at the same time. That is, the elements of socialism and fascism were integrated in a national economy. From 1930 to the 1960s, among others, the Marxian planned economy, the Schumpeterian ideas supporting the monopoly competition with the belief that it would allow to create a more dynamic economy with continuous innovations and strong entrepreneurship, and finally the Keynesian paradigm of demand management policies with active state involvement in the economic activity played a crucial role at that period in the intellectual circles and as well as on the design of economic policies. As has been demonstrated in a fascinating way by M. Schmiegelow and H. Schmielow (1989), the creative application of Schumpeter's theory of innovation and Keynesian theory of demand management demonstrate the retailing pattern of cross-national learning in Japan. In M. Schmiegelow and H. Schmielow's own words,

> "Japan has developed an economic policy system that covers the entire spectrum of contending Western theories: static and dynamic, neoclassical and Austrian (that is Hayekian and Schumpeterian), monetarist and Keynesian, demand side and supply side, neo-mercantilist and neo-liberal theories...A perfectly functional cut across doctrines...has been Japan's secret in coping with uncertainty and change in its domestic and international economic environment." (M. Schmiegelow and H. Schmielow ,1989, 181).

They went even further to suggest the word to take the lessons of being "strategically pragmatic" in explaining the "Japan problem" in the West. More concretely,

> "Obviously endowed with a high degree of awareness of methodological uncertainty in the economic science, the Japanese policy makers were neither tempted by doctrinal overconfidence nor inhibited by doctrinal limitations. They have courageously formulated practical goals in territories forbidden by one economic theory and recommended by another. The problem of the West have more to do with under-utilization of these sources than with the lack of unique Japanese structures" (M. Schmiegelow and H. Schmielow ,1989,183).

The second stage of Japan's modernization lasted from the late 1910s to the mid-1970s. During these six decades, encompassing the years before and after World War II, Japan adapted itself to the twentieth-century industrial system and developed what came to be called "Japanese-style" practices and institutions, which incorporated features of the country's cultural traditions in the practices and institutions introduced from the West.

In the West, following the onset of the Great Depression that started in 1929, the onward march of the socialist planned economy of the *Soviet Union* provoked feelings of crisis about the future of capitalism. During this period, fascism reared its head in Europe, and under its influence Germany moved toward a *controlled economy*. In the United States, meanwhile, the *New Deal* brought a higher degree of intervention in the economy by the federal government. In Japan, the democratic and liberal movement called "Taisho democracy" of the Taisho era (1912-26) was weakened and gradually replaced by a wartime system in social and political affairs. As for the economy, partly under the influence of trends of economic policy in other countries, a kind of *planned and controlled economy* was ultimately adopted as a part of the national wartime system. Under this wartime system, put in place by *the National Mobilization Law* of 1938, the Japanese economy was shut off from the rest of the world. The government worked to see that the country had a full set of domestic industries, and arrangements were hastily established to allocate all resources on a compulsory priority basis in line with national objectives, using bureau critically directed economic planning.

After Japan was defeated in the war, the U.S. Occupation Forces brought an American-style democratic social system and open market economy, but the controlled economy of the wartime regime was left almost intact. This regime was used to promote the postwar recovery and the later period of rapid growth as well. Growth in this case meant above all fostering producers and exporters. The bureaucracy, who was seen as having the ability and responsibility to accomplish this task appropriately, was allowed to exercise substantial discretionary powers.

What has come to be referred to as the Japanese-style system thus originated with the wartime regime that took shape partly under the influence of the German and Soviet models. After the war, along with the introduction of a market economy by the United States, other modifications were made to accommodate the system to the realities of Japanese society. This Japanese-style set of arrangements became firmly established during the rapid-growth period, which began in the mid-1950s. Naturally this system did not carry over all the features of the wartime regime. It cannot be denied, however, that the influence of this earlier situation continued to be felt in the postwar period.

The third and most recent stage of Japan's modernization began in the mid-1970s, following the end of the high-growth period. This has been a period in which the Japanese economy has successfully overcome the effects of two oil crises but has found itself facing a succession of new problems, including pollution, trade friction with the United States and other countries, and a prolonged recession in the 1990s.

2.3- The Initial Western Perspective on Japan After the Second World War

Immediately after the World War Two, Japan was depicted as a society where almost everything was un-modern, the government autocratic, social relations hierarchical and unequal, and the national mentality underdeveloped. For this view, Japan was analyzed as a compact, homogenous and exotic unit, qualitatively different from and fundamentally inferior to Euro-American industrial societies. In this context, the notion of "citizen" was inseparably related to that of modernization: ideally, modern society was defined in terms of self sufficient, autonomous and independent individuals committed to universalistic, rational, libertarian and egalitarian values. Based on these criteria, most of the writers assumed that despite the large-scale industrialization efforts and achievements, Japanese society had failed to produce modern citizens. No matter that this perspective was rejected by a wide range of intellectual circles, these topics, though in various different versions, have been put forward depending on the "conjectural" cycles, particularly, of economy (McCormack and Suaimoto, 1989). One of the Western perspectives on Japan is concerned with production preliminaries. The criticism centered on Japan's production privileged system goes as follows:

> "The important thing is that people read, not what they read, that they participate in the generalized functions of a mass society, no matter they do so as

free individuals, that machines operate, and that not for whose benefit, and that things are produced, not what is produced. It is quite as modern to make guns as automobiles, and to organize concentration camps as to organize schools which teach freedom" (McCormack and Suaimoto, 1989, 3).

This can be considered as the classic statement of modernization, that equates modernization to the rationalization in the sense of neoclassical economics; the attribution of modern values to the means without considering social or human ends amounts to a representation of modernization as an end-in-itself.

2.4- Japan's Response to the West

As Japan astonished the world with its phenomenal economic growth in the 1960s and 1970s, theories of modernization on Japan were given another twist: Where the Japanese tradition had till then been seen as an obstacle in the path of rationalization/ modernization, to be gradually transcended as westernisation advanced, now the Japanese tradition was redeemed and proclaimed a uniquely sited vessel for modernization. This line of inquiry is represented by the "unique Japan" hypothesis. A set of schools have been devoted to explain this "uniqueness paradigm".

2.4.1- The Post-Modern Society Thesis

The post modern society thesis relies on Japan's economic achievements dominated the 1980s as Japan got rid of the "modern" elements originating in the west, and placed renewed emphasis on the traditional, indigenous and "pre-modern" ingredients of Japanese culture. Whether the thesis on post-modern society could be justified or not is beyond the interest of the current study. The most important point related to this perspective is that, not only the Japanese but also several non-Japanese economist observed that Japanese economic patterns were much more similar to that of western practices around 1920s rather than 1960s and 1970s. This finding can be taken as a supportive element to the argument in behalf of "divergence" as opposed to the expectations for convergence hypothesis. This literature around post-modernity thesis motivates one to reconsider other closely associated factors such as "catch up" and "convergence". Patrick and Rosovsky (1985), for instance, underlines the difference between "catch up" and convergence.

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> "Catching up is very much a Japanese perception. It means Japan no longer has a definitive socioeconomic Western model to emulate... Catching up does not imply that Japan will henceforth become more inward-looking...catch up and convergence are not the same thing, despite the existence of several similarities" (Patrick and Rosovsky, 1985, 162).

2.4.2-The "*ie*" Society Thesis

Murakami Kumon and Sato's *ie society* approach constitutes another element of the "unique Japan" thesis. This perspective relies on communitarian orientation of social values, which motivates individuals as opposed to autonomous self and excessive individualism of the Western variant. This perspective gives emphasis on a trans-temporal principle of group formation based upon kinship lineage. The supporters of the *ie* society (household) thesis also argue that their emphasis on the communitarian values and long-termism are not inconsistent with industrialization and economic development. Rather they argue that Japanese historical trajectory is compatible with modernization and industrialization. This perspective has been applied particularly to the corporate culture. It has been suggested that employees should calculate their benefits by looking at long term results of their efforts and the amount they are paid by the employer. A "long-term joint utility maximization in a corporate structure" would imply that after their firms overcome the early disadvantages and bottlenecks and achieve competitive strength in international markets, then the time will come for the material as well as spiritual satisfaction of labor. While corporate organizations along family lines such as Zaibatsu, viewed as a tool control and manipulation, after Japan's striking success story became evident, the *ie* society theorists defined those principles as conducive to a Japanese style corporate democracy.

2.4.3- The Civilizations Theory (*bunmei ron*)

The civilizations theory (*bunmei ron*) attributes primary importance to technology and institutions, as the determining elements of civilisational development. This school includes also geographical and ecological determinants of civilizations. In this sense, geographical zone has wider meaning and importance than boundaries of a nation state, despite they interpret Japan as a single most important exception because in the case of Japan, they argue, national boundaries and civilisational boundaries coincide.

2.4.4- The Confucian Model

The fourth variant is based on the Confucian model. This line of inquiry is best represented by Morishima (1982). With the economic rise of South Korea, Taiwan, Honkong, and Singapore, the concept of Confusion has been injected into the modernization debate. It has been argued that Japan shares the Confucian ethics in the seizing the virtues of austerity, hard work, and submission to the authority, all of which contributed to rapid economic growth. Ironically, Confucianism, which was perceived in the 1950s and 1960s, as an obstacle to modernization is in the 1980s given the status of its facilitator. The extent to which the Confucian zone theory to be used as an ideological tool to justify authoritarian political system remains to be seen. A final note on behalf of the Confucian model is that it has enabled social scientists to reject Weberian hypothesis which argues that the East Asian culture is not appropriate a capitalist mode of development.

Among these explanations of "unique Japan", culture approach might be a better term so as to combine ie society, civilization approach, and the Confucian model. In the next section, we will combine these three approaches together.

2.5- Culture and Economic Development

In this literature, the allegedly peculiar nature of modern development is attributed to a mixture of tradition and modernization in Japanese culture, to western technology and the Japanese ethos and to the encouragement of manipulation by capitalists and government of traditional social attributes. As was summarized in Machperson (1994)'s introductory chapter, xenophobia, emperor worship, and state Shintoism fostered national chauvinism. Frugality and thrift contributed to low income elasticity of demand for consumer goods and high personal savings rates. Loyalty rather than benevolence was the Confucian virtue extolled in Japan. The advocates of the so called School of Culture have given special emphasis on *ie* society because its structures spread to modern organizations. Once the values promoted by the *ie society values* such as encouragement of communitarian values, promotion of communal effort, and stimulation of non-individualistic attitudes, this would support the modern Japanese corporate capitalism with its obligated ties of employee to company, of company to its subcontractors. These explanations are based on national culture (*bunkashugi*) are

giving special reference to *ie* society tradition because as a result of them capacity to cooperate, inclination towards subordination, and loyalty of individual to the group norms will develop. It has also been argued that this national culture for the performance of the economic activity has crucial implications in the sense that it helpes establishing consensus between government, business, politicians, and the citizens in the process of defining national goals and on the means to obtain those objectives (Morishima, 1982, Langlois, 1993, 313). Morishima states that since the ideologies of modernizing leaders were Confucianism the ideology of industrialists was also Confucianism. The important point to be underlined is that, Japanese in such an ideological context had no understanding of western individualism and liking for liberalism. According to the domestic Confucian ethics that were mostly rooted in the Togugawa era, a successful businessman in society was regarded as having done valuable services to state (Lockwood, 1954, 540; Morishima, 1982, 89-92).

For the culture-approach, the Japanese-style market economy is one of the major elements of Japan's civilization and various elements of this system complement each other to form a whole. At the same time, however, the shape of this system has been affected by the country's natural and social environment, that is situational determinism, and by the deliberate will of the Japanese people, particularly those in the leading strata of society. In addition, it seems likely that cultural influences have had an impact. As it was summarized in a precise way in Yamamura (1997, 749), "Japanese capitalism resembles Western Capitalism only in external and superficial ways. It is grounded in the climate and spatial foundations of Japanese civilization and is thus not influenced by Western individualism". This point was strongly underlined in Morishima. He asserts that "Japanese society is a fiercely competitive society, but it does not produce competition between individuals; the individual has to work at the risk of his life on the battlefield of group competition...In spite of her economic success in the post war era, the prospects of individualism and liberalism blossoming and maturing in Japan are still remarkably remote" (Morishima, 1982, 18). For Morishima, ethos and the tradition of self-sacrifice in Japan based on Confucianism is the strongest ideology of the Japanese even today. This perspective has been developed in various forms such as "rolling consensus", "private collectivism", "Japan Inc." (Kaplan, 1972), "Competitive communism" (Kenrick, 1998), and so forth. For culture explanations, four central cultural principles have been at work:

The first is *autonomy of groups*. It is assumed that any group possesses the resources to make decisions concerning matters within the group's sphere of responsibility. Only if the group cannot reach a sufficiently well supported decision by itself will an appeal for assistance be made to some higher authority. This provides, however, serious problems in explaining and understanding the concept of "statehood" in Japan (Wolforen, 1989).

The second concerns the particular way decisions are made by groups. This decision-making process consists of three components:

1- a sufficiently large number of group members should participate in decision making;

2- Among members qualified to participate, decisions must be unanimous; and

3- Unanimity in decision making results in the ability to render an almost unlimited range of decisions considered valid by the group.

The third is a way of thought that has been labeled "Japanese monism," the tendency to blur the distinction between *reality and the way reality is described and viewed*. This reveals itself typically in the desire to avoid speaking or thinking of possible misfortunes or crises lest doing so provoke their actual occurrence, as well as in the "do your best" (*ganbaru*) philosophy that views sincerity and continued hard work as a sure key to successful results. Such phenomena as boundless Japanese faith in technology may also have their source in this way of thought.

The fourth is the tendency to adopt different viewpoints and philosophies intact as a way of making one's own conceptual world richer. This tendency, labeled "hermeneutic thinking" by Yasusuke Murakami, may appear to people of other cultures as revealing a lack of principles or philosophy. But it is possible that this Japanese approach, which accommodates a multiplicity of coexisting ways of thought, may contribute to peace in the future, where interaction among different civilizations and cultures will increase.

As an overall evaluation of the culture school it can be argued that these four cultural elements may have contributed significantly to the emergence of the Japanese-style market economy, particularly because it has promoted the egalitarian values among different groups, it has prevented or minimized wide scale dropouts, promoted the means of consensus-based decision making which led to a system of bureaucratic leadership based on public-private harmony.

2.5.1- A Criticism of Culture Schools

This "extreme" emphasis on the cultural perspective has been criticized because of a lack of explanatory power and also it is being argued that Confucian values can be generalized to other Asian countries. For instance Reischaur insisted the pervasiveness of Confucian mentality in contemporary East Asia, including Japan. For this reason, a more pragmatic and economic reasoning have been adopted in the recent literature. Chalmer Johnson (1992) is one of the strong representatives of this wing. In this literature Japan's success has been attributed to structural flexibility in the face of altering demand and comparative cost conditions, orchestrated by MITI with a cooperative workforce. No matter whatever school is preferred, however, the persistence of traditional and modern structures, sectors, and techniques extends the implications of dualism existing in Japan even today. If the cultural school is put to the one extreme place of paradigms explaining Japan, and the pragmatist approach advocating advantage of economic opportunities to the other end of the scale, three other middle categories should be added

Culture perspective has also been criticized because of the danger of committing the "reductionist fallacy" (Wei-Shun Fu, 1995, 111). He mentions Lehman's causal factors explaining Japan's industrialization for instance, in order to warn us about the danger of reducing the whole to a sole constituent part of it. Lehman (1982, 197) gives the following list of factors; The political revolution and subsequent wide-spread institutional reform, the powerful and progressive role of state, the investment in and development of the infrastructure, import and diffusion of western technology, the rise of an able entrepreneurial class with the close symbiotic relationship with the state, agricultural growth and diversification, the role of silk in generating foreign revenue, advantages of forward linkages centered on textile industry, direct and indirect emphasis on heavy industry through out the entire industrialization period, cheap and disciplined labor, militarism and imperialism.

The important point to note is that even if cultural forces have been at work, they alone cannot have determined the shape of the market system. Here it deserves noting that Japan's prewar market economy was actually close to the Western model, and also that the developmentalism adopted by Japan in the postwar decades has proven capable of adoption by other Asian countries with cultures different from Japan. Even those features of Japan's system that seem to have been heavily influenced by the

country's culture are perfectly capable of being changed - and in fact, such change is now becoming widely evident.

In a similar way, Johnson's reservation about the value of a culture explanation is basically that it is *over generalized* and tends to cut-off rather than advance serious research.

> "Consensus and group solidarity have been important in Japan's economic growth. But they are less likely to derive from the basic values of the Japanese than from what Ruth Benedict one called Japan's "situational" motivations: Late development, lack of resources, the need to trade, balance of payment constraints, and so forth. Positing some "special capacity to cooperate" as an irreducible Japanese cultural trait leads inquiry away from the question of why Japanese cooperate when they do (they did not cooperate during almost half of the period under study here), and away from the probability that this cooperation can be, and on occasion has been, quite deliberately engineered by the government and others" (Johnson, 1992, 8).

He further contends that, in the final analysis it is indeed probable that Japanese basic values are different from those of the western world, but this needs to be studied, not posited; and explanation of social behavior in terms of basic values should be reserved for the final analysis, that is, for the residue of behavior that can not be explained in other more economical ways. Actually, the explanation of the Japanese economic miracle in terms of culture was more prevalent a few years ago, when the miracle had occurred only in Japan. Now that it is being duplicated or matched in the Republic of Korea, Taiwan, Hongkong, and Singapore- and perhaps in some non-East Asian Nations- the cultural explanations has lost much of its original interests.

2.6-The Reverse-Convergence Hypothesis

On the other hand, it must be noted that major proponents of the unique Japan hypothesis contributed to the modernization debate by articulating some key concepts endemic to Japanese culture and language. They brought to the analysis Japanese words such as "*tate*"(terms referring to supposed vertical structure of Japanese society) and "*amae*" (the psychology of dependence which is said to characterize it) without which, they argued, Japanese society and psychology could not be understood. Amaya, for instance, said that "post-war Japan defined itself as a cultural state; holding the principles of liberalism, democracy, and peace, but these were only superficial

principles (*tatamae*); the fundamental objective (*honne*) was the pouring of all our strength into economic growth" (cited in Sakakibara, 1993, xiv).

As Robert N.Bellah argues modernization is what Weber called rationalization, namely, increasing effectiveness of means but has nothing to do with the goal. Opposing the position which views "modernization" as imperative, Bellah maintained that "probably, we are coming close to an age when tradition determines the goal and modernization provides the means to achieve it. Where modernization threatens the goal, modernization itself must be regulated. In a similar vein, Nakane maintains that the same level of "industrialization" does not necessarily entail the same pattern of social structure. Despite the common large-scale transformation associated with "industrialization", she argues, "surprisingly significant differences are discernible between societies" in the area of substantive interpersonal relationships and these differences are attributable to differences in the tradition of each society (Nozomu, 1989, 272). In summarizing these points, Nakane makes the following observations:

> "In modernization theories advocated so far, the view that the so-called base determines superstructure gained currency. Accordingly, the pre-dominant assumption was that, as a level of Japanese industrialization reaches that of the west, her social arrangements must become akin top that of the west as well. Thus, those social phenomena that are not observable in the west tended to be grouped together and to be labeled as Japanese backwardness or the remnants of the feudalism. With other words, according to Nakane, modernization should be equated with westernisation. If there is British style modernization, there must be Japanese style modernization as well. However, the central point is that, while modernization is an abstract and universal process, its concrete manifestation takes different forms depending upon the country. The crux of the matter is not how to make a distinction, if any, between the part, which has undergone changes as consequence of modernization (or industrialization) and the whole, which has remained intact despite such processes. Nakane, for instance, points out that Japanese working in all types of modern organizations are significantly different from their counter parts in the "west" and have not essentially changed since the Meiji period" (Nozomu, 1989, 277).

Nozomu in his evaluation of Nakane's argument, points out that, despite Nakane's weakness in her exposition of industrialization and the "uniqueness" of social structure, her perspective should be positively assessed to the extent that it provided Japanese studies with an approach different from the position in which Japanese society was reduced to a universal and abstract capitalist society. The central focus of analysis in Nakane focused upon the magnitude of the gap in development stages between Japan and advanced capitalist societies.

Moreover, by the turn of the 1980s, there has been considerable contribution of the Western modernization scholars to the "Unique Japan" hypothesis. The underlying characteristics of this newly emerging literature can be summarized as "how to learn from Japan". Dore puts a similar point in more technical language, in his reverse convergence hypothesis. Modernization, he argues, was in the process of being freed of the bias implicit in the assumptions of convergence in a western pattern; instead the west, in particular the U.S., would have to emulate Japan. According to this "revisionist" perspective, the Japanese economy based on principles has objectives, structures, and operating practices that deviate very substantially form the neo-classical Western capitalist model. It is unlikely that there will be a significant convergence even after Japan completes her "catch up" process, because catch-up and convergence are not the same thing at all.

As a matter of fact, the existing differences are the well-known varying emphasis on the some basic concepts by the Americans and by the Japanese. For instance production priorities dominated consumption and consumer rights. The reason is that long-term economic prosperity and high living standards depend on a reliable and able production capacity. The other difference is on the emphasis for national security. In Japan national security has been defined strongly in terms of economic self-sufficiency since the Meiji era. The famous slogan of *fukoku-kyohei*, (rich country, strong army) is the heritage of this era as one of the most prevalent and continuous national vision for economics and national security. Even today, Japan is inclined to define national security in terms of having a formidable technological capacity in order to, first, close the "technology gap" in terms of innovation and, second, achieve autonomy and bargaining power through technology and industrial leadership. These observations point out the weakness of the modernization paradigm in explaining the "goals" of modern economic development and its heavy reliance on the "means" of achieving them.

These may not be seen as fundamental differences at the beginning, but this perspective shows very deep philosophical differences between Japan and other major Western countries: In the USA laissez-faire has become the rule of thumb, whereas in Japan strategic preliminaries determined the direction of market mechanism. For instance, Japan rejected the doctrine of "comparative advantage" and relied heavily on creating capital-intensive, high technology, high value-added industries under the close

guidance of the bureaucracy. Further implications of this difference will be discussed when we deal with Japan's developmental ideology.

In the USA, however, officials were saying that "Why do we want a semiconductor industry? If our guys can't hack it, let them go". Like several others, Clyde Prestowitz, ex-advisory of President Bush for foreign trade disputes with Japan, argues that "the Japanese view of economics in terms of "strategic" priorities is in stark contrast to the view held by American neo-classical economists. The American view simply says that "Potato chips, computer chips; what is the difference? They're all chips" (Prestowitz, 1993, ix). Furthermore, this different attitude led to major differences in the financial system and the corporate structures. As chapter six shows, as a result of establishing different institutions, particularly in finance and corporate structure, companies have been isolated from the dominance of short-term profit oriented share holders, and the possibility of a hostile take-over is minimized by instituting cross-share holding system between different firms of the same keiretsu conglomerate.

As the cost of capital was kept lower, this lead to a high debt-equity ratio in Japan. This means that long-term planning within the firm and entrepreneurial capacity of the managers was promoted. Under these circumstances, market share championship was promoted instead of excessive profitability criteria. This can be considered as one of the strong motivations behind the market penetration power of the Japanese corporations.

As a final topic to the modernization discussion around the Japanese success story is that, material civilization based on modern rationalism has arrived at the point of saturation. We are now shifting away from the modern age to the age, which transcends away from the economy to the culture centered age. In this argument, the "age of Japanese culture", is the age in which Japan "has achieved modernization and took its place among western advanced countries". Japan is the only capitalist society, which has attained a high level of development without sharing the cultural tradition of Western Europe. As a late-developer capitalist nation, Japan partially consists of underdeveloped aspects- namely, not only "feudalistic elements", but also "Asiatic elements", while being at the same time a modern capitalist country which comprises Asiatic cultural characteristics different from those of Western Europe. According to Sakakibara, one of the most popular proponents of the "unique Japan" hypothesis, the Japanese experience in the process of modernization will be useful in considering an

alternative type of modernization different from the West European type (Sakakibara, 1993).

A radically different criticism came from the market approach. Another critical approach to the "unique Japan" hypothesis is that, in fact, a "non-miracle occurred". This school asserts that nothing happened to Japan's economy, but they imply that what did happen was not miraculous, but a normal outgrowth of market forces. This perspective argues that Japanese economic performance as due primarily to the actions and efforts of private individuals and enterprises responding to opportunities provided in quite free market for commodities and labor. While the government has been supportive and indeed has done much to create an environment for grow, its role has often been exaggerated. In other words, for this view, Japan has followed Western models with the most spectacular success: They have adopted and Westerners have forgotten about their own principals (Schmiegelow, M. and Schmiegelow, H., 1989). For this reason frictions are explained as a matter of poor Western performance.

Nonetheless, the reverse-convergence perspective is not also indisputable. Japanese modernization, which is the late-developer type, presents problems associated with the situation in which communal relations of various kinds have survived without being completely dissolved. In this regard, two aspects are significant. One is the aspect in which large corporations and monopoly capitalist makes positive use of the remnants of communal relations. The other is the aspect in which these relations may serve as a momentum to facilitate the formation of a new communal society (Callister, R.R., and Wall, J., 1997).

As the 1980 began to wane, however, some of the problems that had earlier been set aside were re-opened, in particular the relation between economic and political aspects of modernization. Japan was undoubtedly highly industrialized, but if democracy was also a mark of the modernization, where does Japan stand in the ranking order of the democracy? The distinction between modernization as industrialization and modernization as democratization came to be highlighted; there was no doubt that Japan had been modernized in terms of industrialization, but democratization was a different matter altogether.

Accordingly, the famous consensus system of Japanese society, where the "Japan as Number One" is praised, might be seen instead as a sophisticated mechanism of control, through which the masses of the people were regulated in concrete, specific, and situational contexts. From this perspective, group oriented behavior, which an

overwhelming majority of Japan's specialist regard as indicating "consensus from below", might be seen as showing "control from above". Specifically, according to control theorists, the *ringi* system, the total quality control circles, the company excursion practices and so forth could be seen as part of an elaborate and intricate structure of manipulative control (for further analysis, Lincoln, J.R., 1990).

Aside from these problems, there are some other scholars, however, denying even the relevance of the argument formulated so far. In his editorial overview Lehman (1982), for instance, argues that this perspective has two crucial problems: One has been the peculiar, often contradictory and conflictual cultural, political, economic and military relationship between Japan and the outside world, primarily the tension between "affiliation" with the West or with the East. The second, is inextricably linked to the first, has been the relationship between tradition and modernity in Japan. Those terms, tradition and modernity- or the process which the latter is supposed to propel, namely "modernization"- have loomed exceedingly large in the literature on modern Japanese history and indeed continue to occupy the minds and pens of Japanese today and of contemporary foreign observers. Furthermore, implicitly if not explicitly, tradition assumes a regressive quality, while modernity is clearly progressive.

Two problems, however, confuse the "tradition versus modernity" model. In the case of contemporary Japan's much over-emphasized system of industrial relations, it has been pointed out that not only is the alleged community-oriented enterprise primarily a phenomenon of the years since world war two, hence a rather recent "tradition", but that its origins may lie as much in a careful emulation and transfer of practices from IBM as in more in the genius sources. Other than this, it has been proved that one of the most "unique" and "sacred" institutions such as life-time employment, seniority wage system, company unionism were invented during and after 1920 crisis. Gao (1997) asserts that the roots of a whole range of important institutions in the war time control era- including the bank-centered keiretsu (industrial groups based on the Designated Financial Organs System of the time) and the sub-contracting system, which though it existed before the war was greatly strengthened by the forced mergers of the small and medium size enterprises with big machinery manufacturers (the so called "enterprise readjustments").

In fact, around the 1900s, Japan's employment system was pretty much as market oriented as Britain's. It was a conscious institutional innovation which began to shape the Japanese system in the first two decades of the century, perfected the system

of enterprise familism (or what one might call corporate paternalism) in the 1930s, and revamped the system to accommodate the new strength of unions in the late 1940s to produce what is called the 'welfare corporatism' of today (Lehman, 1982)

This point is further elaborated in Johnson. There are several ways in which the government has influenced the structure of Japan's special institutions. Many of these institutions it created directly in the course of its "industrial rationalization" campaign of the 1930's or in the prosecution of the Pacific War. When the government did not create them directly, it nonetheless, recognized their usefulness for its own purposes and moved to reinforce them.

The saving system is an example. It is possible that the savings of private Japanese households are due to the natural frugality of the Japanese. But there are some strong external pressures that encouraged the Japanese to save: a comparatively poor social security system; a wage system that includes large lump-sum bonus payments twice a year; a retirement system that cuts a worker's income substantially before he reaches the age of 60; a shortage of new housing and housing lands, as well as a premium on university education for one's children, both of which require large outlays; and underdeveloped consumer credit system; a government-run postal savings system with guaranteed competitive interest rates; the lack of a well-developed capital market or other alternatives to personal saving; and a substantial exemption from income taxes for interest earned on savings accounts. The government is quite aware of these incentives to save and of the fact that money deposited in the postal savings system goes directly into Ministry of Finance accounts, where it can be reinvested in accordance with government plans. Innate frugality may indeed play a role in this system, but the government has worked hard at engineering that frugality (Horioka and Watanabe, 1997).

This second problem in the tradition versus modernity model is no less intractable. Even assuming the possibility of identifying what is tradition and what is not, it does not necessarily follow that what is traditional is not modern; hence a traditional factor may be a progressive force. Lehmann argues that the same modernity-tradition dichotomy prevails in other culture-oriented school, particularly in Confusion type. The necessity of doing so has emerged not simply from the experience of Japan, but also from the dynamism of peripheral nations, including Korea, Taiwan, Hongkong, and the overseas Chinese communities, especially in South East Asia. Confucianism has been castigated by foreign observers, native Chinese and Japanese intellectuals allied as

a major obstacle to the process of modernization. Today, the common element, which appears to hold together fast-growing economies of East Asia, is their "Confucianist" heritage. In a sense, one can simply put forward the proposition that Japan is a blend of East and West, just as it is (like any other nation) a blend of tradition and modernity; at times the blend has proved to be harmonious, at times not. In that sense, the Japanese studied and absorbed western culture. Not only has Japan's knowledge of western culture enabled the country to develop a competitive edge in the commercial relations between Japan and the Western countries, it has also considerably enriched the cultural life of Japan.

Lehmann, in his critical perspective on the modernization theories on Japan, takes the attention of the reader to one of the recurrent issues of the "unique Japan" hypothesis. It is of course the case that every nation is "unique" Hence the problem with the Japan is not that it is "unique", as this is a universal application, but rather the degree to which it is unique and the extent to which the Japanese have traditionally perceived their uniqueness as a fundamental feature of their society and major propelling force in the development of their history.

One of the major contemporary debates about Japan is whether having achieved successful commercial and industrial power, it will also emerge as a predominant leader in scientific and technological innovation. From a historical perspective, the general orthodox view is that the Japanese have been remarkably diligent and effective in ensuring the transfer of technology from the west to their own environment and that environment has been suitably adopted to absorb "western" technology. The technology history shows that Japan has shown an outstanding performance in adopting and commercialization of technology. There is, however, no satisfactory and conclusive evidence that Japan would close the technology gap and become a pioneer of technological innovations in the near future. For instance, according to 1997 figures, of the 443 persons who have been awarded the Nobel Prize in the natural sciences, 40 percent have been from the U.S., and only 1.2 from Japan. 26.3 per cent of Fields Medal for mathematics have been awarded to Americans and 7.9 percent to Japanese. One other striking figure is that the number of Japanese research personal increased 3.3 times in the last 25 years, but most of them were corporate workers in order to upgrade and commercialize imported technology rather than to innovate (Japan Almanac, 1997, 244).

As observed by Kinzley (1991), if the process of modernization means the transfer, diffusion, and absorption of modern physical sciences and their technological applications, it also inevitably implies introduction of modern social sciences, namely " scientific" approaches to the history, economics, sociology and politics. Essentially the Japanese government sought to get the former without having to include the latter: Physical sciences yes, social sciences no. Indeed by the use of modern physical sciences, it sought to consolidate Japan's military and industrial strength and at the same time achieve massive social mobilization by not only negating modern social sciences, but indeed appealing to very unscientific traditional mythology. Similarly, Odagiri underlines that "path dependency takes place because a major part of the capability of the firm is accumulated through experience and learning..." (Odagiri, 1997, 465). One significant implication of this "path-dependence" view is that change in the major institutional elements of the system, such as corporate structure, government-business relations, and political economic system of the Japan's "corporate capitalism" is unlikely, at least, for the near future to change completely.

2.7- The Paradigm of "Free-Rides"

Another school tries to explain the success of Japan on the ground of "free-rider" paradigm. Robert Gilpin (1997) is one of the pioneers of this perspective. Particularly the influence of pax-Americana after the Second World War era, Korean War, and free-trading regime on the performance of Japan has been brought into the agenda by this perspective. The theory of "free rides" argues that Japan is the beneficiary of its post-war alliance with the United States, and that this alliance accounts at least for the miraculous part of Japan's rapid economic growth, if nor for all of it. There are three ways in which Japan is said to have enjoyed free rides: a lack of defense expenditures, ready access to its major exports markets, and relatively cheap transfers of technology.

For Johnson, although it is true that Japan has not had to devote much of its national income to armaments, this factor can not have influenced its growth rates significantly. If Japan's overall rate of investment had been very low then the demands of defense could have had a retarding effect. But in Japan, where capital formation exceeded 30 percent of GNP during high-speed growth, the effect of low defense expenditures was negligible. The case of South Korea and Taiwan, which have been pursuing the high investment strategies of Japanese with equal or even more spectacular

results, illustrates this point: Their very high defense expenditures have had a little or no impact on their economic performance.

The case of exports is more important. Japan profited enormously from the open trading system that developed throughout the world after world war second. To a large extend Japan utilized the benefits of the established international institutions as the General Agreements on Tariffs and Trade (GATT), the International Monetary Fund (IMF), and until 1971, stable exchange rates- all institutions that they had no role in creating. Historical accounts also underlines the validity of same argument for Japan. The historical observation that Japan's great economic achievements came in the relatively open periods of world commerce- from the Meiji Restoration to World War one and from 1945 to 1970- MITI bureaucrats have expressed concern that the post 1970s era could look like 1920-45 when seen in historical perspective.

Nonetheless, the important point for our discussion is that Japan's growth did not depend nearly so much on exports as it did on the development of domestic markets. By the late 1960s, Japan's exports were only 9.6 percent of GNP, compared for example with Canada's 19.8 percent from 1953 to 1972, Japan had a consistently lower dependency on export and imports as a percentage of GNP at constant prices than France, Germany, Italy, Britain or OECD Europe as whole. Japan's exports run at about 11.3 percent of GNP, and its imports at 10.2 percent, whereas the OECD European figures were 21.2 percent and 20.9 percent respectively. There is no question that Japan, as a heavily populated resource deficient country has to export in order to pay for its vital import, but foreign sales were not the main factor driving its economic activity during high speed-growth (Johnson, 1992).

Home-demand led Japan's growth for the twenty years after 1955. The demand was there of course, before 1955, but with the coming to power of the Ishibashi and Ikeda opened up domestic demand as it had never been opened before. Balance of payments problems slowed positive finance during the "bottom -of -the –pot" recession, but the economy responded quickly to government discipline and rebounded in the Iwato Boom of 1958-61. The propelling force of the economy in this and later periods was private corporate investment nurtured by favorable expectations for the longer term that were created by the governments; it was not export sales (Maki, 1998).

Technology transfers were not free of cost, but there can be no question that were crucial to Japanese economic growth and that the prices paid were slight compared with what such technology would cost today, if it could be bought at any price. Japan

imported virtually all of the technology for its basic and high-growth industries and it imported the greater portion of this technology from the U.S.A. But it is trivial and misleading to refer to this movement of patent rights, technology, and know-how across the Pacific and from Europe as free ride.

The importation of technology was one of the central components of post-war Japanese industrial policy, and to raise the subject is to turn the discussion to MITI and the Japanese government's role. Before the capital liberalization of the late 1960s and 1970s, no technology entered the country without MITI's approval; no joint venture was ever assigned to without MITI's scrutiny and frequent alteration of the terms; no patent rights were ever bought without MITI's pressuring the seller to lower the royalties or to make other changes advantageous to Japanese industry as a whole; and no program for importation of foreign technology was ever approved until MITI and its various advisory committees had agreed that, the time was right and that the industry involved was scheduled for "nurturing". Johnson, however, underlines that the process of technology transfer should be seen a much more complicated matter rather than a simple free rides. He inclines to explain technology transfer agenda in by industrial policy of successive Liberal Democrat Party governments in the Diet.

2.8- The "Developmental State" Argument

Johnson, therefore lies in the realm of a developmental state, a term Johnson himself coined. In explaining his choice and understanding of the term "developmental", he clearly and carefully distinguishes it from any conventional government intervention. Due to tens and dozens of reasons several governments even in the most pure forms of market economy intervene to the working of the price mechanism in order to increase market outcomes. The crux of the problem is not directly related to intervention versus non-intervention. The determining and even distinguishing aspect of Johnson's "developmental state" is related to *how* and for *what* purposes this intervention has been done in Japan.

Moreover, he refers to "plan rationality" rather than "market rationality" in explaining his position towards developmental state. By an excerption from Henry Jakoby he also attempts to distinguish developmental state from the "regulatory state" of the early Industrial Revolution. For Jakoby, after the major transformative achievements of the First Industrial Revolution from a traditional way of society

towards the new concepts such as efficiency in production, effectiveness in competition, and free movement of goods and services across the markets, that is national boundaries became prevalent. Under such circumstances, taking the absence or underdevelopment of social security, the state had to take responsibility for the protection and welfare of the individual. That is, in this period individualism and competition were the rules, the state emerged as a "regulatory" mechanism in order to off set the adverse impact of this system.

In the case of late comers to industrialization such as Germany, the United States, and France, however, the state had to take much more direct initiative in order to close the development gap between the pioneers and reap the benefits of being late comers for a successful catch up process. This is the distinction between the "regulatory state" and the "developmental state". In this sense, the regulatory state coincides with market rationality whereas the developmental states come close to plan rationality. In the case of market rationality, the state is concerned with the efficiency of competition but not with the kind of industry among those where this competition is taking place. The developmental state, by contrast, has its dominant feature precisely in the setting of such substantive social and economic goals, which entails a wide-scale and well-defined industrial policy with strategic preliminaries in order to create a desired market structure so as to increase national competitiveness. In this sense, as will be elaborated in detail in chapter four, strategic orientation of the Japanese State has been one of the strong continuities of Japan since the Meiji era onward.

At the beginning of the century, this strategic vision was to increase industrial production (*shokusan kogyo*); later it tuned out to be rich country, strong army (*fukoku kyohei*); productivity movement (*seisanryoku kakuju*); promote export (*yushutsu shinko*); full *employment (kanzen koyo*); and high-speed growth (*kodo seicho*). After the internationalization of the Japanese economy and the resistance of the private sector toward further bureaucratization of the Japanese economy, the developmentalist aspects of the Japanese State have turned out to be much more regulatory, and have been labelled as "administrative guidance". The consistency and continuity of its top priorities, observes Johnson (1992, 305) "generated a learning process that made the state much more effective..." the state industrial policy and its required institutional innovations. This distinction, in turn, brings about four implications at systemic level.

One of the most striking tradeoffs between market rationality and plan rationality, for Johnson, is the emphasis of "efficiency" of the previous, and the

"effectiveness" of the later. It is because of this varying emphasis on the "efficiency" versus "effectiveness" that the Japanese have been allowed and therefore have been blamed of allowing wide-scale inefficiencies in the economy such as agriculture, small retail stores and so on. There is a deep difference in attributing value judgement to the economic activity in terms of "means" and "ends". In the a case of effectiveness, since it entails at least certain degree of strategic vision, the final performance is excessively result oriented.

The third fundamental difference is that, the "plan rationality" requires a strong social consensus on the goal of polices as well as the functions. As the plan rationality is fostered by a strong social consensus, is much more powerful in obtaining pre-determined goals in a fastest way. In the existence of confusion and conflict, however, it is open to severe market failures. That is, plan rationality is much more effective in case of routine problems, while market rational system is effective in dealing with critical problems and contingencies.

Fourthly, the decision making centered in the hands of bureaucracy for the plan rational system and in a parliamentary assembly in the market rational system. Motivation for change in plan rational system is marked by the disputes and rivalries among functional fighting and conflicts between different ministries, expected natural outcome of which, is wide scale corruption, bureaucrats, and ineffective monopolies due to resistance of private sector in order not to lose their achievements of clientele relationships.

Japan's choice for such a planned rational system instead of a market rational system has been closely related to Japan's situational imperatives such as late development, lack of resources, the need to trade in order to finance imports of goods and services, balance of payment constraints and so forth. Its inefficiencies, however, in case of crisis triggered by external or domestic factors, have been observed since the collapse of the "bubble" economy in 1990.

2.9- The Role of Institutions

Another prevalent type of analysis of the Japanese "miracle" stresses the influence of "unusual" Japanese institutions. This is by far the most important of the four isolated, and the one that has been more closely discussed in Japan and abroad. In its simplest form it asserts that Japan obtains a special economic advantage because of what post

war Japanese employers habitually call their "three sacred treasures"- the life time employment system, the seniority (*nenko*) wage system, and enterprise unionism. This is sometimes called Japan's "*uchiwa*" (all in the family) economic system. This aspect of the Japan's corporate structure was introduced to the business management literature and known as the theory-Z. The argument goes as follows, because of these institutions Japan obtains great labor commitment, loses fewer days to strikes, can innovate more easily, has better quality control, an in general produces more of the right things sooner than its international competitors (Johnson, 1990, 39).

Like Sakakibara who argues that Japan's capitalism is different and should be considered an alternative capitalist development model, Robert Ozaki (1991) also underlined that the latest stage in capitalist development is "human capitalism", a stage in which the interest of human resources is central, and this state has been reached in Japan. What factors, then, are composed of this "human capitalism" so as to make it more desirable compared to other forms of "bad capitalism"? As we have discussed before, Ozaki's "human capitalism" suggests that despite the failure of strict modernity in considering the "goals", privileges, and security considerations of a society, modernity itself should be regulated and limited. Like Ozaki, Sakakibara in his latest article (1999) argues that as a part of western modernity, neoclassical economics should be regulated and reformulated so as to explain "real" priorities of a society. Sakakibara's vies, however, closely related to George Soros's 1997 article on "the threats of capitalism".

Soros argues that, without extreme emphasis of neoclassical economics on selfish interests and regulation of "information, particularly the one pertaining the future financial markets and instruments it is unlikely to prevent a world economic crisis in the future. After the collapse of fascism and communism in Europe, as the major threat to the "open society, the final and, perhaps the most serious threat, now is this unregulated capitalist system.

It is well known that in conventional economics, capitalism is defined in terms of private property, rights, and markets. Given self-interested individuals and assumed self-equilibrating mechanism, the end result of market allocation is the best optimal achievable allocation, that is Pareto-Equilibrium. This is characterized by a specific theory of a firm, a specific idea about the functioning of the markets, and an argument for minimal government intervention. In short: firms are either production functions, or a nexus of contract. Markets are exchange mechanisms, where contracts coordinate

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DOKÜMANTASYON MERKEZİ

behavior between unanimous agents and prices supply sufficient information. The government intervenes in cases of market failures and imperfections. The focus of government is on safeguarding of competitive process. The end result of those " free" markets can not be other than optimal. The companyism during1930s differs from the one around 1960s and 1970s in terms of its heavy reliance on the repression of labor and consumers. For this reason, this era has been criticized because of large-scale "social dumping", clearly at the expense of consumers and the shareholders.

In institutional economics, however, the nature of capitalism is fundamentally different. As it is discussed in the first chapter, the conception of capitalism as a historical formation with distinctive political and cultural as well as economic properties derives from the work of those relatively few economists interested in capitalism as a "stage" of social evolution. According to this perspective, the position of Japanese capitalism can be distinguished as follows: Based on communitarian values, management of the firm is controlled by a variety of disciplining mechanism in such a way that the interest of plurality of stakeholders is served. Not only the shareholders, employees, but also suppliers, customers, members of the business group, and the local governments are all stakeholders. Transactions are largely internalized inside the firm, (internal labor market) and inside the keiretsu (capital, intermediary goods, technology, and information), because contract in the Japanese model is relational.

Crucial is the managerial autonomy, which enables management to develop long-term relationship and reciprocal contract. Control of management by stable stakeholders is based on the theory that conceptualizes the firm as an evolving set of capabilities. Such a vision of the firm has consequences for the type of diversification (related instead of unrelated), the type of innovation (incremental instead of radical), and for the finance of investments (group bank, instead of capital markets).

The mutual monitoring among stakeholders is stimulated through a common interest in the well being of the firm as whole. A strong rivalry among firms belonging to different groups provides high-powered incentives to allocate efficiently also in the short term. The ideal type of Japanese relational capitalism combines the better of two worlds: High-powered incentives from competition among rivals and long-term trust among horizontal and vertical stakeholders. As Karel van Wolferen contributes to the discussion, Japanese capitalism is difficult to understand in terms of power structures, as a system without a clear leadership. Understanding of this power structure, upon which a national capitalism has been established in Japan, has crucial importance

because the primary source and motivation for change in capitalistic development process is closely related to the search for efficiency and conflictual interest among the power-holding groups and/or individuals.

Both in politics and business, leadership is shared and decision making diffused. Labor is controlled in the interest of the firm, firms, in turn, are controlled in the interest of the industry, and industries are controlled in the interest of "the Japan Inc.," Because of the many checks and balances in the Japanese society, changes take place slowly, and conflicts are settled in such a way that no one interest group overrules the others. That is, capitalism is change, but the dynamics differ from the Anglo-Saxon variety to the Japanese kind. Changes in capitalism are certainly driven by more or less external forces such as political integration, technological developments, international alliances, mobility of financial capital, and the like (Soros, 1997).

On the other hand, there are several reservations to this school. First, the three sacred treasures are not the only special institutions, and they are certainly not the most sacred, others include the personal saving system; the distribution system; the "descent from heaven" (*amakudari*) of retired bureaucrats from the ministries into senior manager positions in private enterprises; the structural industrial groupings (*keiretsu*, or the oligopolistic organization of each industry by conglomerates); the "dual economy" together with the elaborate structure of sub-contracting it generates, the tax system; the extremely low degree of influence exercise over companies by share-holders, the hundred-old "public policy companies" and perhaps most important of all, the government controlled financial institutions, particularly the Japan Development Bank, and the "second", or investment, budget (the fiscal investment and loan plan). The fact that Japan's dual structure consists of small and medium size enterprises on the one hand, and large business conglomerates on the other should also be considered within the boundaries of institutional structuring. Among these, those working as subcontractor are considered as the "shock absorbers" or what I would prefer to call "buffer institutions" of the Japanese business cycle. This is true especially when the fixed labor cost becomes a unbearable burden on the large firms and in this situation the burden is being shifted to the small firms at the other end of the subcontracting chain.

In a similar way, Japan's distribution system, despite wide ranging criticism from foreigners, serves as an insurance system against unemployment during time of business down turn because of the extensive middle-men employment at the level of wholesale trading. As will be discussed later in chapter six, life-time employment

enables full-capacity utilization, prevents horizontally opposing labor union movement and even further it allows labor to cooperate for the sake of technological and organizational progresses even of the labor saving type.

It should be underlined here that the so-called "three sacred" treasures of Japan should be seen as the result, or at most, a part of the whole structure rather than the determinant of the whole. One other point to be noted is that, institutional innovations are necessary, but not a sufficient condition of a sustainable efficient development model. Institutions, like any other living entities, have limited life spans and therefore must be exposed to the pressures and influences of both external and internal parameters for change. In the next chapter, theoretical discussions on the nature of institutions in economic development and the related empirical observations will be provided. It is also intended to show what would happen in the total or partial absence of institutional innovations.

To conclude this chapter, in the post-bubble period, there is no doubt that Japan is in the process of structural transformation. A set of reforms in administration, fiscal structure, finance, trade and production is being implemented now in order to achieve a more transparent, accountable, open, and competitive economy. Despite the fact that under the pace of recent and other necessary reforms, Japan's model would change and even converge towards Anglo-Saxon type of a market economy. Nevertheless, we should be careful in this prediction and should retain the famous "Japan residual" due to fact that Japan is changing not because it is being demanded by the west, but because of Japan's peculiar needs stemming from its "situational determinism".

III- INSTITUTIONS, ORGANIZATIONS, AND ECONOMIC PERFORMANCE: Setting the Problem

Japan's rise to economic power and its invariable comparative success in adjusting to critical conditions of the world economy in the last past two decades was a profound challenge to Western economic theory and political doctrine. The distinctive features of this performance have been rationalized either in terms of particularly "faithful compliance" with one or of the another given theories or in terms of particularly "striking deviations". The former one, that is the compliance approach, says that Japan's experience is explainable by compliance with more than one, if even conflicting theories (Schmiegelow and Schmiegelow, 1989).

The ongoing debate among economists consists of the following threeframeworks that purport to explain Japanese enterprise structure. Firstly, a *market approach* that emphasizes the economic characteristics of an enterprise as a response to market opportunities; secondly, a *cultural approach* that sees organization as the expression of patterned values; and, finally, an *authority approach* that explains organization as a historically developed structure of domination which incorporates elements of market and culture explanations, but does so from the view point of historically developed authority relations that existed among individuals and institutions (Whitley, 1992; Hamilton and Biggart, 1988).

Among the Western originated paradigms, especially neoclassical economics, each failed to bring about a full-fledged explanation for the "Japan problem". This is reasonable because mainstream economics studies the allocation of scarce resources among competing ends. It does not, however, study human action. Instead, neoclassical economics provides a "formal theory of rational choice, which assumes away questions of ignorance and uncertainty, time, and social institutional change. Contemporary economics, under the influence of Vifredo Pareto, assumed that people can be modeled as functions with given tastes and preferences. With the contribution of Gerard Debreu, economists started assuming that the action of an agent is merely a point in the so-called "commodity space". Based on this framework, the signature of human kind was eliminated from economics. It was, as Frank Hahn argued, as a final stage, that the individual can disappear altogether, with no substantive loss to the theory" (Prtchitko, 1995, 2). That is why,

> "it can be argued that the mainstream promotes methodological 'atomizm' rather than a meaningful methodological individualism. That is, it builds model economics composed of rational, isolated agents, rather than socially situated people. It focuses on the allocation, rather than genuine human action. It tries to predict, rather than understand, every day life". (Prtchitko, 1995, 1-5)

For instance, "rigid wages and long tenures in internal labor markets were attributed not to social pressures or a new industrial feudalism but to implicit contracts optimally structured by rational employers and employees faced with otherwise difficult problems of shirking and bad faith. In the same manner, severe wage discrepancies between categories of workers resulted not from restrictions on entry based on differences in group power, but from optimal arrangements for distributing talent in society" (Granovetter, 1992, 4). As the third example, vertical integration occurred not because of the suppliers' conspiracy against the public denounced by Adam Smith, but as arrangements to reduce transaction costs in markets where business had become too complex to conduct between independent units (Williamson, 1985).

In short, as economics have been divorced from the basis of human action at the micro level and turned out to be "social physics", its predictive and explanatory power for individual actions and diverse path of economic development in different contexts has weakened. This is reasonable because economic activity, as the result of an interaction among resources, technology and human beings, reflects values, motivations, incentives, and attitudes, -the cultural cadre of a society. "The process of economic development is not restricted to economic change but is essentially a transformation of the human agent and his social environment within which economic activity unfolds" (Adelman, Mears and Pepelasis, 1961, 161). On the other hand, the impact of cultural values, social and economic institutions on economic behavior and economic organization might constrain or foster development depending on the way of institutionalizing economic activity. At this point, in his elegant article on the nature of institutions and institutionalism, Peterson argues that "the crisis confronting our system of market-based, big-government, democratic capitalism is essentially institutional in nature..." (Peterson, 1997, 270) because economy is itself an "instituted process" in terms of change, transformation, and progress (Adams, 1994). Institutions are important because they influence economic life through a variety of channels, e.g., consumption attitudes, modes of economic organization, labor efficiency, attitudes toward entrepreneurship, and of course, the general outlook for life. In order to understand the

significance of institutions, following questions should be brought into the agenda: What are the major forces that shape our economic lives? What institutions are critical to the economic process? What, precisely, is the nature of crisis we now confront? And finally, how can we improve market performance?

The main economic forces that shape our daily lives center around capital formation, technology, labor and its skills, human needs, the distribution of welfare among citizens and finally, allocation of resources between competing uses. For this reason, it is reasonable to analyze interactions of these parameters between different segments of society with a reference to the power structure within the society, pattern maintenance, and historically evolved network and structures. In other words, emerging economic outcome is the result of the interactions between economic performance and the nature of organizations and the way they are institutionalized in a given society over a given time period.

3.1- Different Paths in Economic Development

This institutional problem that we face can be handled on three different but complementary "pathways". These pathways should be taken as analytically useful devices for exploring the factors that determine the organization and performance of markets.

3.1.1-The Modern Industrial Organization Pathway (MIOP)

This resembles modern oligopoly and the imperfect competition theory and associates empirical work on the same theoretical framework. The Basic concern of MIOP is on the nature of equilibrium under the relevance of basic economic and market conditions and the comparison of it to the "first-best" equilibrium that can be obtained in a perfectly competitive market with complete contracts and no information asymmetries.

By specifying certain basic economic and market conditions that characterize production costs, product demand, the number of suppliers and consumers, the information available to economic agents, and the nature of the behavioral interactions between them, the MIOP gives fairly sparse consideration to *institutional environment* in which market interaction takes place. In addition to ignorance of this pathway of institutional environment, it is also not concerned with the *governance structure* that

defies boundaries between firms and markets, the organization of firms, and institutional responses to various transaction costs (Wolff, 1986).

Despite these ignored points, however, the relevance of this approach is that it is concerned with different forms and degrees of imperfect competition between purely competitive models and pure monopoly. It shows the underlying logic and legitimacy of vertical integration or nonstandard contracts as the attractive governance alternative either to respond market imperfections or to enhance the functioning of the market..

3.1.2-The Governance Structure Pathway (GSP)

In general, this pathway is one of the transactional and behavioral characteristics that define the boundaries between firms and markets, vertical and horizontal expanse of firms, contractual relationships, legal and regulatory institutions emerging and adapting in response to transaction cost of various kinds, all from a comparative institutional perspective.

The line of inquiry in this pathway is best represented by the work of R. Coase (1937) and Williamson (1985). Research in this tradition generally takes the institutional environment as given (exogenous) and does not define it with great precision. The main research question of this pathway is on understanding the reasons why *various* behavioral and institutional arrangements emerge and adapt in response to the challenge of "economizing" on the costs of making transactions between economic agents. This approach underlines the well-known market imperfections such as information costs, its asymmetric distribution between agents, and incomplete contracts. It also underlines that although economic agents are self-interest seeking, they are operating under the "bounded rationality" constraints. Institutional and contractual arrangements emerge to reduce the direct and indirect costs of acquiring inputs, manufacturing products, and selling goods and services. The relevant transaction cost includes both the direct cost of making a transaction (i.e., writing a check or a contract), the cost of contractual breakdowns (i.e., opportunism, shirking etc.) and the associated costs incurred in connection with rent seeking behavior and defenses against it.

In short, understanding why alternative organizational and contractual arrangements emerge in markets with different transactional characteristics- the governance structure that determines how transaction between economic agents are organized monitored and consummated- is the essence of research along the GSP.

3.1.3- The Institutional Environment Pathway

The institutional environment pathway concerns itself with the formal and informal institutions governing property rights, liability rules, contract law, bankruptcy law, antitrust policy, regulatory laws, social norms and customs. The primary objective of all these approaches is to better understand technological, behavioral, and institutional factors that determine market organization and performance both statically and dynamically (Joskow, 1995, 251). More succinctly, the three frameworks allow us to understand how and why markets and the firms in them are structured, how suppliers, consumers, workers, and intermediaries in these markets behave, and how these markets perform in terms of prices, costs product quality, innovation, risk allocation, and other performance criteria. Our primary concern in this study, therefore, is confined to the understanding of the institutionalization of the relationships between market, business enterprises, and the state.

3.2- Institutional Economics and the Economics of Institutions

An overall evaluation of the effects of institutions on economic growth was made by Morris and Adelman (1989). Their findings on the historical experiences suggest that;

1-Institutions are the main determinants of both the *pace* and the *structure* of economic growth. Domestic institutional changes, however, are the most potent dynamic factor determining internal *diffusion* of growth and its benefits.
2-Appropriate institutions, while *necessary* to economic growth, were *not sufficient*. Economic and demographic influences mattered: export markets, initial resources, the size of the agricultural surplus, techniques, population, and immigration were all important.
3-No unique progression of economic and institutional change marked 19th. century development experience. Different types of countries experienced very diverse patterns of economic growth.

Around current discussions, both speed and diffusion of growth are of importance. Based on these overall findings, they argue that the *speed* of economic growth in the European periphery and land-abundant oversees countries depended on

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market systems, land tenure arrangements, and foreign dominated institutions that provided factors of production such as land, labor, capital and entrepreneurship. This observation is also confirmed by North (1993). Among these factors, market institutions established clear property rights, freed economic transactions and facilitated factors and goods mobility. On the other hand, land tenure arrangements determined the strength of cultivator incentives.

The *diffusion* of growth, on the other hand, depended on the strength of domestic relative to foreign institutions, the class structure of political power, the distribution of land holdings, and on government economic policies. These influences, as they have been observed, determined who had assets and skills and thus who could respond to expanding market opportunities. The *impact of market institutions* differed depending on whose assets were increased, who held political power, whose political power , whose property rights were strengthen, and in what manner factor mobility was promoted. Based on this observation, it should be underlined that although market systems and incentives are powerful force for economic growth, the strengthening of market systems fails to spread the benefits of economic growth widely unless they are backed by the appropriate institutional arrangements. Accordingly, the relevant suggestion based on empirical evidences is that *in order to realize the benefits of market systems, institutional adjustments has to be done in concurrence with market institutions*. As Morris and Adelman put;

> "Japan illustrates how in large countries following import-substitution policies the predominance of viable, moderate-size agricultural holdings and effective national political institutions combined with restricted influence of foreigners over domestic economic policy to produce widely diffused domestic growth" (Morris and Adelman, 1989, 1424).

The rational of our emphasis on the role of institutions as complementary to the market mechanism is because of the existing cost of transaction associated to the exchange process which might undermine the relevance of the market system. As we have touched upon before, the neoclassical model which takes institutions exogenous to the system holds only under the severely restricted assumptions of zero transaction costs; but that *with a positive transaction costs, institutions matter.* This is reasonable because ever since Adam Smith, it is well-known that *specialization* and *division of labor* have made possible the improved *productivity* that arises from technological change, better resource allocation, and specialized production. These are the key

underlying features of modern economies. As one of the natural implication of specialization and division of labor, international trade and gain from trade have been recognized keys to the wealth of nations (North, 1993).

In recent years, an important strand of economic inquiry has been devoted to the process of division of labor and specialization in and between countries because of the fact that since this process is not taking place in a vacuum, and this exchange is not free of cost. Gains from trade, therefore, are reduced due to existence of transaction cost, associated to the very nature of this exchange process, mainly due to the expansion of regions that economic activity takes place. This observation on historical experience of development strongly confirms the existence of a trade-off between production and transaction costs. That is, the measured transaction cost of a society where density of interactions between societal networks is low, because the motivations and opportunities for cheating, shirking, and opportunism are minimized, if not totally eliminated. Under such circumstances, North argues, "they simply do not pay" (North, 1989, 1320). However, while measured transaction costs in such societies might be low, production costs are high, because specialization and division of labor are limited to the extent of markets that can be defined by personal exchange. In an extended market society which can be characterized *as specialized interdependence*, exchange is impersonal, where goods and services or the performance of agents is characterized by many valued attributes, in which exchange takes place over time, and in which there are not repeat dealings. In this situation there are gains to be realized by engaging in cheating, shirking, opportunism. This means high transaction cost associated to the exchange process.

In order to prevent such activity, elaborate institutional structures such as formal contracts, bonding of participants, guarantees, brand names, elaborate monitoring systems, and effective enforcement mechanisms must be devised that constrain participants and therefore minimize costly aspects of exchange process. This, in turn, implies that "all specified and well-enforced property rights means that resources devoted to transacting are large, while productivity associated with gains from trade is even greater. That is why, high rates of growth and development have characterized most of the western societies" (North, 1989, 1325).

This is, however, only possible as the result, *first*, of the development of a third party to exchanges, namely government, which specifies property rights, and enforces contracts; and *second* the existence of norms of behavior to constrain the parties in

interaction. As a matter of fact, the rise of impersonal rules and contracts means *the rise of the state, and with it unequal* distribution of coercive power. This provides, in turn, opportunity for individuals with superior coercive power to enforce the rules to their advantage, regardless of their effect on efficiency. That is, rules will be devised and enforced on behalf of the interests of the politically advantaged but they will not necessarily lower the costs of transacting in total (Olson, 1982).

As was noted in both North and Olson, one of the most evident lessons from history is that political systems have an inherent tendency to produce inefficient property rights, which result in stagnation or decline (North, 1989, 1321). Until now it has been shown that institutions are a matter, particularly, in the existence of transaction cost, as an inseparable part of the exchange process. In the next section, the basic characteristics of institutions will be discussed.

3.2.1- Characteristics of Institutions

The term institution is often used to refer to the following characteristics:

a- They have also organizational features, i.e., the extend to which organizations and institutions coincide.

b- They have formal structures.

c- They are created at a specific *time and place* by a specific means, as opposed to having evolved from more diffuse sources,

d- They are embedded in, as opposed to differentiated form, other institutions.

e- They are defined on universal, as opposed to particularistic, ground in the *terms* they serve,

f- They are creating, as opposed to simply maintaining, a certain public good.

g- They are identified with their technology links.

Considering these diverse aspect of institutions, there are, mainly, two strands of analysis in explaining institutions. The first emphases behavioral perspective in which institutions are complexes of norms of behavior that persist over time, by serving collectively valued purposes. The second emphases the relation to their formal or rules-bounded characteristics. According to the second view, "institutions are the rules of a society or of organizations that facilitate coordination among people by helping them for expectations which each person can reasonably hold in dealing with others" (Nabli

and Nugent, 1989, 1334). Based on these characteristics three more common and concrete aspects of institutional efficiency are defined based on three criteria.

a- The *rule and constrain nature* of institutions. These are known as perceptions commonly used by a set of participants to order repetitive and interdependent relationships.

b- The *ability to govern* relations among individuals and groups on the basis of some set of rules either voluntarily accepted customs, or traditions or formal rules that are enforced by an authority via coercive incentive systems in regulating social relations.

c- The predictability or stability of institutions for simplicity in repeated relations in the present and future course of actions.

Formal organizations such as labor unions, and employer's organizations are institutions because they provide sets of rules governing the relationships both among their members and between members and non members. Likewise, *markets* such as labor markets, credit market, stock-exchange market, whole sale/ retail market are also institutions because there are sets of formal or informal rules regulating transaction operations in three respective markets. *Contracts*, either explicit or implicit, are also institutions in that they also lay down rules which govern specified activities involving the parties to such contracts. In addition, cultural rules and codes of conducts are (informal) institutions in so far as they can constrain the same relationships between actors.

This historical observation on the role of institutions and institutional design on economic development is recognized by the representative of the so called "old" and "new" institutional economics despite some varying degree of emphasis and with some methodological differences.

3.2.2- The "Old" and the "New" Institutional Economics

Institutional economics was initiated by Thorsten Veblen as a critique of neoclassical and Marxian economics particularly in *The Theory of Leisure Class: An Economic Study of Institutions* (1899). Veblen's criticism of neoclassical economics concentrated on the conceptualization of actor as a *rational economic agent* (REA), defined as a *lightning calculator of pleasures and pains who operated in a static and timeless world.*

Although Veblen did not neglect REA in the process of decision making, he argued, however, that this is inadequate as a useful abstraction even for simple thought experiments in economics *per se*.

(T)his alternative perception of economic activities of an agent is elaborated in a *historical time* so as to permeate the essence of economic progress. More concretely, in the Veblenian analysis, the critical driving force in economic behavior is the *creativity* which was later developed by Schumpeter as the driving force behind capitalism (Schumpeter,1934). Veblen's analysis was followed by Commons (1934), whose central concern was on the role of institutions. Commons saw some *institutions as facilitating collective action which would lead to economic development* (Rutherford, 1994). In Commons's approach, *organizations and technology* pertaining to the institutions constitute the central gravity of economic development.

In a perfectly competitive environment, mainstream economics emphasizes the allocation of resources, the determination of income, output, prices and the distribution of income as the basic problems of economic engineering, whereas institutional economics, sees the organization and control of the economic system as the central problem. In accomplishing this task, instead of relying on price mechanism alone, institutional setting is viewed to have strategic importance.

The rational behind this reliance on institutions is based on the initial view of a market as comprising of a number of different types of institutions that coordinate economic activity (Polanyi, 1944). The interactive links between the market institutions and other institutional arrangements in a society, as embodied in law, culture, custom, and ethical behaviors are considered as explicitly effective power structures and are strongly affected by legal rights and the role of governmental agencies. More precisely, in the line of Polanyi's approach to the market as an instituted process, "institutional approaches are inclined to define the market as an asset of social institutions whose functions are assumed to both regulate and establish a consensus over prices and more generally to communicate information regarding products, prices, quantities, and potential buyers and sellers" (Hodgson, 1989). An integral part of this approach is that *power relations* constitutes the central mechanism in governing economic activities in the sense that prices are set *administratively* rather than by the interaction of demand and supply curves in the sense of Walrasian general equilibrium (Arrow, 1981).

Based on these premises, institutional economics are focused on the formation of institutions, the changing relationship between economic and legal systems, the

relationships between power and belief systems and the effect of technical change on institutional structures. Reasonably, then, the anathema of institutional economics is that, in an uncertain world, the agent is forced to rely on institutional rules and standard patterns of relations that all participants accept as prevailing norms and conventions (Keynes,1921). In Robinson's terms,

> "A society can exist unless its members have common feelings about what is the proper way of conducting its affairs, and these common feelings are expressed in ideology. From the stand point of evolution, it seems plausible to say that ideology is a substitute for instinct. The animals seem to know what to do; we have to be thought. Because the standard of proper behavior is not passed on in the genes, it is highly malleable and comes up in all sorts of different societies, but some standard of morality is necessary for every social animal.....On the other hand, social life is impossible unless the pursuit of self-interest is mitigated by respect and compassion for others. A society of unmitigated egoists would knock itself to pieces; a perfectly altruistic individual would soon starve. There is a conflict between contrary tendencies, each of which is necessary to existence, and there must be a set of rules to reconcile them. Moreover, there must be some mechanism to make an individual keep the rules when they conflict with his immediate advantage" (Robinson, 1962, 5)

This institutional context, therefore, provides a better payoff matrix to all because of continuous contact, and exchanges of information through other institutions which help to achieve private interests at a societal level. That is, the multitude of communication among different sects of the society provides information, increases trusts, reduces uncertainty about the action of all other agents and finally produces a predictable environment, depending on the nature of norms, conventions, routines of social culture and institutions.

Based on this observation, we tend to criticize mainstream neoclassical economics mainly because of its extreme emphasis on individual preferences, technological opportunities, physical capital endowments, and market opportunities as the main kind of constraints on economic activity.

3.2.3- The "New" Institutional Economics

As we have noted before, there are several different pathways through which we can understand common issues associated with firms, market organization and performance. Considering our objectives for the next chapters, in analyzing current Japanese economic crisis, it is necessary to juxtapose a new institutional economic

(NIE) perspective to the analysis. The reason is that a the NIE is sensitive to feed backs and interactions between the institutional environment and the structures, behaviors and performances of the firms and markets. In other words, the NIE would provide a broader spectrum in which we can analyze the causes and the consequences of different kinds of institutional and organizational differences and the governance structures in the way of "economizing" transaction costs in increasing market performance. Hence, it is note worthy to underline the basic difference between the "old" and the "new" institutional economics.

The NIE has some fundamental differences in comparison to the *old institutionalism* in the sense that the NIE is associated with *methodological individualism* and takes the economic agent as *given*. Other than this difference, the "old" and the "new" differ the because old institutional school recognized the importance of institutions in economic activity but its emphasis on theoretical content and validity of the model was not sufficient. Contrary to that, the neoclassical theory attributes too much importance to the theoretical abstraction of economics as a discipline, but invariably underestimated the relevance of institutions. The NIE, on the other hand, is an attempt to combine these aspects, that is theory and institutions, into the body of economic discipline.

The "old" and the "new", however, still share strong similarities both in their criticism of neoclassical economics, and suggestions of in terms of institutional solutions to the current problems. Like the "old" institutional economists, the proponents of the "new" one such as Commons, Mitchell, and Ayres criticized neoclassical arguments at four levels:

a- its ignorance of institutions,
b- its overemphasis on the rationality of decision making,
c- its excessive concentration on static and equilibrium as opposed to disequilibrium and dynamics, and
d- its denial of the changing nature of preferences due to *repetitive* and *habitual* aspects of behavior.

As the basic research agenda is confined to the comparative efficiencies of institutions, the NIE's main concern is the emergence and evolution of institutions and of their *comparative efficiency,* rather then of the institutions alone (Knack and Keefer, 1995). Due to this comparative assessment of institutional performance, the possibility

of alternative institutional trajectories as competing paradigms in economic development is recognized in the NIE. Although the NIE is not a unified and homogenous body of knowledge, in the present study institutions will be considered in terms of, first, a transaction and information cost approach and, second, a collective choice perspective.

An earlier attempt for a relevant explanation of the emergence of cost in economic organization came from Ronald Coase (1937) who argued that a firm exists due to *emerging transaction cost* in the market place. In other terms, a firm as an organization can be viewed as a compensating mechanism in reducing or minimizing transaction costs associated to the market processes. These costs include those of information, negotiation, monitoring, coordination and enforcement of contracts. In this sense, the Coasian approach to the institutions is named as the *transaction cost economics.* According to this comparative institutional approach to the study of economic organization, transaction is made the basic unit of analysis. Further contribution to the transaction cost economics in this line of inquiry, came from Williamson (1985). His contribution is important because he combined *bounded rationality and opportunistic behavior* into the economic analysis.

A second dimension of transaction cost economics is related to the so called property rights. In accord with this view, there are technological as well as some other progresses which lead to apparent externalities giving rise to the kind of institutional mechanism for internalizing externalities known as property rights. Although under the assumption of well defined and designed property rights, conflicts will be reduced and cooperation will be facilitated, in the presence of transaction costs, however, different systems of property rights yield solutions of differing efficiency. In other words, *the nature and* extent of transaction costs might lead to the different kind of organizations and thus alter the relative importance of the market.

Transaction cost economics maintains the presumption that organizational variety arises primarily in the service of their efforts towards transaction cost economizing. Coase mentioned different *kind of costs that are related to the exchange process.* This process naturally gives rise to differentials in the structure of organizations. These are, *firstly*, the cost of discovering what the relevant prices are; *secondly*, the cost of negotiating; and *thirdly*, concluding a separate contract which takes place on the market base. Based on this process, the Coasian transaction cost can be summarized as the cost of *bargaining*, the cost of *decision making* and the cost of

policing and enforcing contracts. Coase's plausible hypothesis, therefore, implies that non-market exchanges survive because of their relevance for specialized contracts and heterogeneous products.

In the light of Coasian tradition of thought, one might argue, than, that in the absence of transaction costs, the assignment of property rights might lead to efficient exchange among actors through bargaining and negotiation. This assumption, however, is relevant under the availability of information for every one, which is not perfectly viable. This final point constitutes the third aspect of transaction cost economics. It is related to *incomplete and asymmetric information,* under the existence of which *"adverse selection"* and *"moral hazard"* emerge during an exchange or contractual process between participants because asymmetric situation provides incentive for opportunistic behavior such as shirking and/ or cheating. This process might lead to extensive *market failures*. As a response to the participant who takes advantage of asymmetric information and uses it at the expense of the second participant, the second participant will search of additional information in order to, at least, minimize his/her loses. This process of searching also entails the emergence of extra costs of transaction in the contractual process. This last point takes us to the agency problem

Because of transaction and information cost, we encounter another well explored *"agency problem"* in the exchange arrangements in which the action of one individual, "the agent", affects an other individual, *"the principal"*. This "agency problem" is applicable to any kind of economic activity in which one agent is endowed with better or superior resources such as land, labor, and capital whereas the other might have comparative advantage in other resources such as human capital and experiences which led them to enter into any contractual arrangement or exchange process. That is why the cost of transacting might be extensive and so high as to make the market process totally meaningless because of extensive market failures taking place unless some sort of *"incentive mechanism"* capable of preventing or minimizing the problem of moral hazards and adverse selection are developed.

A final relevant note on the NIE is that it is inclined to explain efficiency and distributional implications as well as the determinants and evolution of institutions. Since institutions generally attempt to satisfy certain goals and adopt structures such as incentives, division of labor, rules for entry, exit, decision making and external relations, all such aspects of institutions should be considered in explaining institutional efficiency. Institutional efficiency can also be measured according to their capacity in

resolving emerging conflicts between the agent and the principal. Based on this short exposition on the NIE, we can argue that after defining precisely a set of principal-agent problems in the course of economic activity, we will be able to establish a complete frame-work for introducing distributional considerations as well as efficiency considerations into the analysis of market organization. This is important because it would allow us a better understanding of the feed back between market performance, regulatory institutions and their behavior. Before shifting our emphasis to the nature of principal-agent relations, an explanation of the institutional and organizational structure in which they are coordinated should be provided.

3.2.4- Institutions and Organizations

For the purpose of clarity, it might be relevant to distinguish institutions and organizations from each other. North's distinction between institutions and organizations is a good starting point for discussion in the context of the present purpose. His argument relies on a distinction primarily on the *rules* and the *players*.

> "The purpose of the rules is to define the *way the game is played*. But the objective of the team within that set of rules is to *win the game*-by a combination of skills, strategy, and coordination; by fair means and sometimes by foul means. Modeling the strategies and the skills of the team as it develops is a separate process from modeling the creation, evolution, and consequences of the rules" (North, 1990, 4-5)

Organizations, on the other hand, "include political bodies, economic bodies (firms, trade unions, family farms, cooperatives), social bodies, and educational bodies. They are a group of individuals bound by some common purpose to achieve objectives. Modeling organizations are analyzing governance structure, skills, and how learning by doing will determine the organization's success over time. Both which organizations come into existence and how they evolve are fundamentally influenced by the institutional framework. In turn they influence how the institutional framework evolves... the emphasis is on the interaction between institutions and organizations. Organizations are created with purposeful intent in consequence of the opportunity resulting from the existing set of (i.e., institutional) constraints ..." (North, 1990, 6)

What is implicit in this kind of approach to the relations between institution and organization is that organizations would perform better if they adopt rules and constitutions that protect property rights as well as enhance private incentives with

regard to activities with high positive externalities. For this reason, North traces the success of the British path of development to the *institutionalized separation of political powers* which constrained the sovereign from predatory public finances.

North's argument suggests that in the process of industrialization, organizations are *passive*; they merely express the supposedly unambiguous institutional scheme. Khalil's criticism of North is that "it could be the case that the same institutional scheme is used differently by the same organization at different stages of its development. That is, there is no one-to-one correspondence between the set of institutions and the performance of the organization". (Khalil, 1995, 446) For Khalil, North's distinction stems from the basic difference between *ends and means*. While ends define the organization, means include-besides material and technological resources- paradigms and conventions or, in short, institutions. Agents act according to ends in light of means. Based on this distinction, "organization denotes an agent as pursuing ends-irrespective of whether the ends are objective tastes or purposes. The term institution is about the means needed to pursue the ends- irrespective of whether the institutions are about efficient conventions or enabling paradigms" (Khalil, 1995, 450).

The reason of our emphasis on this distinction is that although the establishment of appropriate *institutions are the necessary condition for economic performance, but still is not the sufficient condition for it.* Organizational capacity should be considered as the sufficient condition for it. For instance, we might have property rights protected and externalities correctly internalized by institutions, but that would not make agents favor income over leisure or prefer a low discount rate of future streams of income.

Assuming the validity of this argument, it can be used as an analytical tool of explaining economic performance. Apart from exogenous dynamics of decline such as invasions or natural disasters, *endogenous* story of decline captures organizational failures as much as institutional failures. If, for instance, organizations are not sufficiently motivated for appropriate and dynamic process of division of labor- i.e., agents heavily discount future consumption or prefer leisure rather than working, there would not be an economic growth even if we have efficient institutions. This suggests that any "correct" mixture of institutions does not guarantee persistent economic growth unless this supported and complemented by the required organizational measures. In Khalil's words,

> "In fact, the most successful civilizations have divergent institutions should highlight that economic development may be a function of tastes of organizations as much as of institutions... Evidence shows that similar rules can create different behavior and outcomes. Thus, what matters, besides the erection of the "correct" institutions, is an analysis of the behavior of the organization, which varies during the historical process." (Khalil, 1995, 462).

As will be discussed in the next two chapters, organizational efficiency of Japanese firms has been attributed to the supposedly "unique" Japanese personality, principles of distribution of wealth, and cultural attitudes. While culture matters, it can not be treated in abstraction from the goals and preferences of the organizational actor. The same cultural values could enhance or inhibit economic growth, depending on the tastes of the actor. The policy implication of this analysis on the distinction between institutions and organizations is that institutional reforms should be handled with organizational reforms in order to obtain optimal outcomes from this reformation process.

As will be analyzed and critically evaluated in the third chapter of this study, a country can protect property rights, promote income distribution based on productivity, and avoid predatory public finance. But that may not produce economic growth if the tastes of households remain strongly in favor of other choices inhibiting economic growth.

This distinction enables to make further elaboration in comparing market and non-market institutions as complementary incentive mechanisms. As Menard (1989) argues, the Coasian perspective argues in favor of non-market institutions as alternative cost minimizing organizations are appropriate in the sense that they do not emerge erroneously. They are not even a secondary mechanism to be subordinated to the market sovereignty. They are rather fundamental organizations of every economic system organized for obtaining individual and/or societal goals. At this stage, two point should be underlined. First, it is unlikely that past or future extensions of the market system can undermine such institutional dimensions of transaction. Contrary to that, formal and informal institutions will keep their functions in improving market performance. Second, within organizations, it is not expected also that contractual arrangements can or will gradually erode the customary and informal rules and regulations because "as uncertainty remains undiminished and the dynamism of the capitalist system creates ever greater complexity decision makers, and therefore,

reliance on some informal rules and customs can never decrease to insignificance" (Hodgson, 1988, 30-40, Hodgson, 1993)

Given the relevant institutional rules of the game, hierarchical organizations as the important economic agents in any market society they, or their controllers, exercise considerable discretion over the acquisition, use and disposition of human and material resources. They function as economic actors by integrating, coordinating and controlling resources through an *authority system.* It is this authoritative nature of decision making within organizations which distinguishes them from the pure market (Williamson, 1985). While it is generally accepted that the possibility of achieving and establishing a cost reducing 'symmetrical relationship' within organizations is relatively easier and higher compared to the market, Alchian and Demsetz attract our attention to the problem of *"teamwork"* in organizations.

As a matter of fact, given the existence of *collective action* within organizations, there is always difficulty of measuring individual contribution to the collective effort. This is reasonable because "a price mechanism is non-existent in the firm, and rational calculation of cost and benefit becomes impossible as we move away from market institution" (Coase, 1937, 209). Since we have an *indivisible production function,* and the price mechanism is ceased to exist within hierarchical organizations, an alleviation of such problem requires a *"monitor"* to minimize shirking among the work force, and allocate rewards to their owners. So it is this function of "employer" that provides the characteristics of market to the firm. This function is realized by interpreting, coordinating and controlling resources through an authority system. As Dore (1986) suggests;

> "The relative efficiency and technological dynamism of an organization stems in part from *obligated relational contracting* with in organizations. This differs from formalized arrangements of a letter of the written contract. In that it is tempered by duty, trust, and give-and-take. (This also takes place) ...in the context of long term relations of this type, both within and between firms, and not from a mystically ubiquitous market "flexibility" where each agent forcefully pursues his or her own interest solely or mainly, in terms of explicit calculus of individual benefit or loss, and where the literal word of the written contract is taken as the substance of all relations" (excerpted in Jonklin, 1991, 373).

Dore (1994)'s suggestions are also supported also by Hodgson (1994)'s recent research papers, where he argues that organizations improve the capability of economic agent to maximize his or her "satisfaction" by contributing his limited computational

capacity through the means of providing trust, harmonizing conflictual interest, increasing information and knowledge in an environment where there are uncertainties and complexities.

The institutional solution to uncertainty, however, is not the same as that of the market, but closely related to the structure and methods of administration and control. The institutional approach says that the nature of hierarchical organizations is a kind of protective enclave from the potentially volatile and sometimes destructive, ravaging speculation of a competitive market, because they have the ability to store and reproduce large number of gene like habits and routines (Hodgson, 1994, 95). Thus, the firm contains great masses of skills and technologies upon which its productive capabilities depends (Coase, 1937, 209). Empirical analyses which were carried out particularly in the context of Japan vindicate the same points outlined above. Aoki's analysis of the Japanese firm, for instance, reveals that performance and efficiency of the organizations are positively correlated with the level of cooperation and trust between members (Aoki, 1984).

Another important field where the role of organizations becomes significantly strategic compared to a pure market environment is in their potential and capability to contribute innovation and research and development (R&D) efforts in the existence of market contingencies. Contrary to the market, the firm functions as a protective shelter, as we have mentioned before, in which long-term R&D can take place in particular. This role becomes more crucial in the development of future technology, which is so riddled with radical uncertainty that no comprehensive futures market of this type could exist. The firm as a relatively durable organizational structure is able to deal with the lack of knowledge about the future fruits of R&D and innovation.

Despite organizations having these potential features, their effectiveness in performing expected functions crucially depends on the nature of other non-market institutions and the nature of relationships among them. Viewed from the present perspective, the state constitutes an exceptional position because the state has the monopoly of coercive power. Once this monopoly is controlled or manipulated by any kind of pressure and/or interest group, this power might be used against third parties, which in the final analysis, might hinder the effectiveness of the organizations. In this context, a set of problematic areas such a collective action, collusion, free rider and principal-agent problems in organizing economic activity, in general, will be discussed.

3.3- Collective Action

The problem of collective action and the elimination of " the free rider problem" constitutes an important problem within organizations. The key issue in the collective action literature is *to explain collective outcomes in terms of individual motivations*. The problem of collective action emerges when self-interested individuals do not find it profitable to participate in the provision of the public goods. However, because of embedded indivisibilities, public goods are open to the benefit of even these kind of individuals and therefore the free rider problem emerges.

In order to evaluate this problem, the theory of collective action pays special attention to the nature of organizations in terms of their size, age, purpose, group identity, and homogeneity in evaluating their performance (Olson, 1982). The theory of collective action has been concerned with public/collective goods in terms of their physical character such as environmental pollution, any kind of infrastructure and abstract character such as wages, prices, tariff, quota, tax rate and rules of regulations.

The relationship between interest groups and the state, on the ather hand, constitutes increasingly important place in the theory of collective action literature because the role of the state in mediating the network of relationships between different groups is not neutral and passive. Contrary to this, the state and its agents are an organic part of this process which provides the infrastructure of *rent seeking*. Rent seeking agents are concerned with the means in obtaining the result they want.

The concept of the state is not used here for attributing to it any meaning of neutrality as a non-market institution, but it is believed, at least in the framework of the present study, that it opts for the particular class interest by reproducing the rules of the game as a strategy to justify its position towards particular attitudes within the societal strata. The prevailing form of state and other institutions in a society stems from certain historical conditions that force the state to create and promote strong intermediate powers, each having considerable autonomy, with the state acting as a coordinator of activity and mediator of conflicting interests. In other words, the position of the state and its relations with, so to say, business were not inevitably dictated by the market but emerged from historically developed visions about the position of the state towards societal objectives.

One important note here is that both transaction costs and collective action perspectives, among others, have one important common denominator. Because the

role of government is emphasized in both transaction costs and collective action component of the NIE, they should be explained in a mutually interactive scheme. On the one hand, government decisions affect transaction and information costs of different economic agents and thereby their choice of organizational forms a type of contract. On the other hand, different agents and groups have incentives to organize themselves in such a way as to influence government decisions in protection of their interests. As Nabli and Nugent underlines,

> "...when any individual or group finds that at least from its own perspective, the existing contractual alternatives, macro rules or other institutions are inefficient, inequitable or both, that individual or group is a potential for engaging in collective action to change the contracts, macro rules or both in such a way as to improve the outcome for itself" (Nabli and Nugent,1989, 1340).

In this context, viewed either from the point of a transaction cost approach, or from the view point of a collective action perspective, the role of the state in organizing, mediating, and coordinating economic activity and setting the rules of the game becomes crucial.

3.4- Conflicts in Principal-Agent Relations and Institutional Solutions

Put in its simplest terms, a conflict of interest arises when the private interests of a politician or official clash or even coincide with the public interest. Classic examples of conflict of interest include:

- A legislator approaches a minister on behalf of a company in which the legislator is a shareholder.
- A minister accepts an offer of future employment from a company which is currently seeking a government trading license.
- A public official must decide from a number of options on the route of a new highway - one option would reduce the value of his family's farm.

At this stage the following questions should be asked: what is an interest, what is a private interest, what is public interest, what constitutes clash of those interests, and when does a coincidence of interests raise an ethical dilemma, or turn out to be labeled as "corruption"? The relationship between *conflict of interest and corruption* helps to elucidate the nature of both. Of the two phenomena, corruption is the better known. As for their relationship, it can be argued that all cases of corruption involve a conflict of

interest but the reverse cannot be maintained. More specifically, corruption involves a clash between the official's private and public interests where usually a financial benefit is knowingly obtained at the expense of the public interest. In other words, corruption is the "misuse of public power for private profit". Corruption lies at one extreme of that spectrum of conflict of interest.

The meaning of conflict and corruption from the view point of statehood as seen by the citizens in a democratic society has crucial importance. It is well-known that the fundamental premise of all governments is that the power of government derives from the people for whom it serves. In other words, there is a trusteeship created between the people and those who serve in the three branches of government: the legislature, the executive and the judiciary. Members and officers of each of those branches exercise an ever-increasing power over the rights and liberties of individuals, the economy and the commercial system. That trusteeship requires the exercise of power for the people's welfare, that is, in the public interest.

For legislators, ministers or officials to decide a matter even partly on the basis that it will benefit his or her private interests is to betray the trust of the people. The decision must be made solely on the basis that it is in the best interests of society. For to allow any other consideration, may result in a decision other than that most appropriate in the public interest. The primary test is subjective, that is, one which the politician or official must apply personally according to his or her own conscience. Since the stability of government rests on the maintenance of public confidence, both free society and democratic governments require a high degree of public confidence in the integrity of those chosen to govern. This confidence can easily be eroded by the appearance of a conflict of interest. For this reason, the ethical requirement for legislators, ministers and officials is to avoid both actual, potential and apparent conflicts of interest. Its avoidance becomes one of the rules of the game when the objective of the game is the pursuit solely of the public interest.

3.4.1- Accountability of Government

From the view point of principle-agent relations, the basic institutional problem in this study is twofold: How to enable the government to intervene in a good way and how to induce agents to obey the directions of the state in a way so as to maximize their own profits or whatever the nature of their satisfaction they define. According to the analysis

until now, it has become clear enough that a pure market mechanism alone is not efficient and therefore institutional intervention would improve market performance. In the context of an institutional intervention paradigm, the state has an important role to play not only in assuring material security for everyone and pursuing other social goals but also in promoting economic development. The generic problem, however, is that nothing guarantees a beneficial state intervention, at least to everybody.

The trend in many political systems to adopt mechanisms to support the integrity of its public officials as a part of wider phenomenon of government accountability. The concern with the integrity of those who exercise that power is simply the torch of public accountability being shone on another level of the decision-making process. It is another example of the *checks and balances* so eloquently explained by Thomas Madison in the Federalist No 51:

> "If men were angels, no government would be necessary. If angels were to govern men, neither external nor internal controls on government would be necessary. In framing a government, which is to be administered by men over men, the great difficulty lies in this: you must first enable the government to control the governed; and in the next place oblige it to control itself." (Cited in Przeworsky, 1996).

If the government is to perform well, the bureaucracy must be effectively overseen by the elected politicians who, in turn, must be accountable to citizens. In particular, politicians must use the private knowledge that citizens have about the functioning of the bureaucracy to monitor bureaucrats while citizens must be able to discern who is responsible for what and sanction them appropriately, so that governments that perform well remain in office and those that do not lose it. If these mechanisms were well designed, an economy with an interventionist state would perform better than markets left to themselves.

As Przeworsky (1996) discussed, once we understand that markets are inevitably incomplete and economic agents have access to different information, we discover that there is no such thing as "the" market, only differently organized economic systems. The very language of "the market" subject to interventions by "the state" is misleading. The problem we face is not of "the market" versus "the state", but of specific-institutions that would induce individual actors-whether economic agents, politicians, or bureaucrats-to behave in a collectively beneficial manner.

To put the agenda in a different way, what can be done in order to induce an agent to work for the benefit of principal as well as for him/her self? When some

markets are missing and when particular individuals have access to different information, relations between classes of actors are those of principals and agents, tied by explicit or implicit contracts (Mankiw, 1998, 581)

Agents have some information which principals do not directly observe. They know their motivations, they have also privileged knowledge of their capacities, and they must have a chance to observe that principals cannot. They also undertake some actions that are, at least partly, hidden from the principal. One general problem facing the principal is as following: how to induce an agent to act in principle's interest while meeting the "participation" constraint: That is providing agent with income or utility above the next best opportunity, and the "incentive compatibility" constraint, that is, allowing agent to act in self-interest."

The "economy" is a network of multifarious and differentiated relations between particular classes of principals and agents: managers and employees, owners and managers, investors and entrepreneurs, but also citizens, politicians and bureaucrats. The performance of firms, governments, and the economy as a whole depends on the design of institutions that regulate those relations. What matters is whether employees have incentives to maximize effort, whether managers have incentives to maximize profits, entrepreneurs have incentives to take only good risks, whether politicians have incentives to promote public welfare, whether bureaucrats have incentives to implement goals set by politicians.

As shown in Olson (1982), institutions organize all these relations. Moreover, institutional efficiency is also measured according to their capacity to contribute to those problems that are purely economic such as between employers and employees, owners and managers, or investors and entrepreneurs, those that are purely political, such as between citizens and governments or politicians and bureaucrats, as well as those that structure state "intervention" those between governments and private economic agents. If the economy is to operate well, all these principal-agent relations must be structured appropriately. For the goal of our study, three classes of "principal-agent" relations should be addressed.

1- Between the government (politicians and bureaucrats) and private agents.

2- Between the elected politicians and appointed bureaucrats

3- Between the citizens and elected politicians.

The performance of an economic system depends on the design of all these relations. Private agents must benefit by behaving in the public interest and must suffer when they do not, and so must bureaucrats and politicians.

3.4.2- The Market, Economic Agents, and Government Regulation

The role of the state in economic development is different from other economic actors since the state sets the incentive structures among private agents by exercising the legally qualified or legitimate coercive power. In other words, the state permeates the entire economy; it is a constitutive factor of private relations. Problems of institutional design, therefore, cannot be avoided by *throwing the state out of the economy.*

On the other hand, the agenda of regulation is not free of problems. The generic problem in any governmental regulatory process is that the regulated firm has information about some of its conditions, such as its cost of production or the demand for its outputs, which is superior to the information available to the regulatory agency such as government, appointed bureaucrats. Moreover, this firm undertakes some actions, which the regulator cannot observe directly but can only either infer from outcomes or monitor at a cost. The regulator has a legal authority to set prices or rules. Once the regulation is issued, according to the nature of the structured incentive scheme the firm decides whether to produce and how much. "The regulator's problem is then to set up the optimal trade-off between the rents of the firm and the surplus of the consumers" (Przeworsky, 1996, 8).

Due to the existence of asymmetric information and hidden actions, the "first-best" regulation is not possible. The firm will always extract some rents because the regulator will be constrained by the available information at hand. That is why, the neoclassical argument in favor of non-intervention has its persuasive points. Any kind of intervention, at most, is a "second best optimal relation".

Moreover, since any kind of state intervention has distributive consequences, different groups affected by regulation-firms, industries, employees, consumers, or public action lobbies - have incentives to seek regulation that benefits them and resists these that hurt them. The regulators can in turn benefit privately by supplying the interventions sought by the private actors. These private gains may consist just of being (re)elected, but also of getting rich while in office or once out of office.

As a result, regulation may induce collusion via clientele ties between the regulators and the regulated groups. To this extent, regulation is "endogenous" that is, it is supplied in response to the demand by the groups potentially affected by it. The problem of commitment constitutes another dimension of regulatory paradigm. The problem of commitment stems from the moral hazard of the principal, in this case the government. If the government would want, for instance, the firm to invest, and once the firm does invest, the government wants to tax away its profits, then in this situation we have a problem of "bad commitment".

In this particular case, the principal-agent problem is related to lack of sound legal infrastructure concerning the property rights of private economic agents, that is agency. Of course in a modern state the property rights can be, to various degrees, guaranteed or protected by the legal institutions, such as a constitution, but it is not possible to specify everything in advance and must leave leeway for legislative discretion as well as judicial interpretation. Moreover, constitutions can be changed also. This means that property rights are inherently insecure.

While bad commitments lead to the under utilization of resources due to insecure institutional environment, this process harms the motivations of people under the expectations of incredible commitments targeting special interest groups or allies, rather than those of the nation. As Przeworsky excerpts from Laffont and Tirole observe, "the cost of commitment is that the government may identify with the firm and bind the nation to a bad outcome over the long run." (Przeworsky, 1996, 10)

Hence, the central institutional issue of state reform is how to enable governments to make good commitments while preventing them from making bad ones. Even if commitments were to be good policies, it is not easy to make them credible. Spiller (1995) shows the difficulty of making credible commitments in different institutional contexts. In different countries commitments are enforced by either (1) judicial review of decisions of regulatory bodies, (2) highly detailed legislation, or (3) contracts between the government and the firm, enforceable under contract law.

Yet none of these conditions guarantees that governments will intervene in the public interest. The very capacity of the state to intervene makes it an attractive target for influence by- private interests and the very ability to commit opens the possibility of collusion. Hence, there are reasons to expect that the quality of state intervention in the economy depends on the internal organization of the state- in particular, on the relations

between politicians and bureaucrats-and on the design of the democratic institutions that determine whether citizens can control politicians.

3.4.3- The Bureaucracy and Delegation

Despite the fact that the state has a unique position since the state sets the incentive structures among private agents by exercising the legally qualified or legitimate coercive power, many of the functions of the state and all of the services that the state supplies to citizens are delegated by the elected representatives to someone else, specifically to the public bureaucracy. Delegation is inevitable because in a complicated society desired outcomes can be achieved only by delegating authority to related experts.

Delegation, however, raises the standard of principal-agent problems. As it was underlined before, since a priory specification of all the relationships among actors is not feasible under contingencies, executive and administrative agencies are left with a significant degree of discretion. But the objectives of bureaucrats need not be the same as those of citizens or of the elected politicians who represent them. Bureaucrats may want to maximize their autonomy or the security of their employment, render clientele favors to friends and allies, shirk in office, aggrandize their budgets or simply get rich. Again, they have private information concerning the benefits and the costs of their actions and they undertake actions that cannot be observed directly but only inferred from outcomes or monitored at a cost. Hence, delegation must inevitably give rise to agency costs.

Some of the agency problems inherent in managing public bureaucracy can be enumerated as the following: Perhaps the most important among them is the difficulty of providing incentives and eliciting information when the performance and thus output depends on joint actions of multiple agents. Under such conditions the principal can observe only the output of the team.

As we have discussed earlier in this chapter, in such a situation the members have incentives to shirk and to hide information from the principal. The difficulty here lies in the nature of the work that bureaucrats undertake. Bureaucracies are more frequently monopolies, which in turn implies that there are no comparative yardsticks by which their performance can be evaluated. For instance, the performance of management at Toyota can be compared to that of Nissan, but this manner of measuring

performance is not available when the Japanese bureaucratic mechanism is considered. Cross-country comparison of bureaucratic performance might not be viable or logical due to national differences and priorities.

Faced with these difficulties, public bureaucracies are more prone to rely on conformity with rules rather than on incentives. What can be done to alleviate these agency problems? Przeworsky mentions six principles.

1- *Designing contracts*. Even with difficulties of monitoring individual efforts of team members, the principal can create incentives for the agents by (1) setting wage levels sufficiently high to attract agents of high quality, who have higher opportunity costs, (2) offering sufficient career advancement (which entails wage differentials), and (3) setting monitoring systems that will make job loss likely in the case of bad performance.
2- *Screening and selection*: the recruitment to the public sector must be sensitive to costly signals such as education, which indicate the potential performance of the agents. That is, merit based screening and selection must be the rule, rather than exception.
3- *Institutional checks*: Agents are often in a position to do more harm to the principal than to simply withdraw effort: embezzlement, insider trading, official corruption, and abuse of authority are all testaments to this fact. Whenever an agent can take actions that might seriously jeopardize the principal's interests, the principal needs to thwart the agent's ability to pursue such courses of action unilaterally. Their solutions are institutional checks requiring that when authority has been delegated to an agent, there is at least one other agent with the authority to veto or to block the actions of that agent.
4- Creating multiple principals or multiple agents with dissonant objectives. Most of the governments are divided in such a way that it is not the task of any particular position or agency to maximize general welfare, yet their interaction is supposed to generate this effect. One example is the division between "spending ministries" which are supposed to promote substantive goals and the finance ministry which is supposed to control spending. The idea is that decisions are based on more information when this information is gathered by several agents, each of whom is charged to find arguments in favor or one policy or project, than when it is gathered by one agent charged to find the information relevant to all projects.

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DOKÜMANTASYON MERKEZİ

5- *Creating competition,* either between state agencies and private counterparts or among state agencies in the exclusive sector. While there are some costs due to duplication of effort and perhaps economies of scale, competition facilitates the measurement of performance and, if combined with right incentives, enhances performance.

6- *Decentralization:* The main argument in favor of decentralization is related to the public accountability of bureaucrats. In fact, provision of public services enhances the accountability of the government by bringing it closer to the people it serves.

Finally, public bureaucracies are different from private firms in one fundamental way that opens the possibility of a more effective monitoring. State services are produced and delivered by a bureaucracy, whose members are appointed by politicians. Citizens' control over the bureaucracy can be only indirect. Citizens can at most consider the performance of the bureaucracy when they sanction - elected politicians. Hence, while state bureaucracy is supposed to deliver services to citizens, it is accountable to politicians.

In a nutshell, what is argued here is that government intervention can be effective if the regulatory institutions are well designed and that politicians can better control bureaucrats if they solicit the cooperation of citizens. But the question that still remains open is whether politicians will want to intervene well and to control the bureaucracy.

3.4.4- Empirical Evidences on the Principal-Agent Problems

Before focusing on the principal agent problems, it is preferred to give a brief summary of cross-country studies concerning the impact of relevant institutional frameworks in economic development. It is being argued from the onset of this study that one of the relevant methods to pursue in understanding the relevance of an institutional analysis in the current study is to make a retrospective search of the empirical validity of institutions in economic development. If the problem is put with some specific questions, how much material progress has mankind made in modern times and how much has this progress been affected by the choice of the institutional framework designed to bring it about?

At a broadest generalization, most of the Western industrial countries chose an institutional framework that permitted a wide latitude of individual initiative, choice,

and responsibility, whereas some other countries either in the West or in other party of the globe at different times, chose a different combination of state control, and economic planning, with a concomitant de-emphasis of individual initiative. Depending on the chosen economic and political ideology, different combinations of pure individualism or liberalism and statism have been chosen. Each set of economic and / or political system has its own realm of consistency and plane of legitimacy. To the mercantilists, for example, the legal, political, and economic institutions of mercantilism were justified in the public interest of increasing the national wealth. With a more familiar example, the protectionist policies of the post-second world war era in most of the developing world was justified with the view that the gap between the poor and the rich nations was caused by a vicious circle of poverty that required "draconian" measures to break.

What is underlined here is that the choice of an institutional framework of the economy has consequences for the allocation of resources (efficiency) in the economy. What the observations underline is that differential in performance between economies are the results of differences in the efficiency properties of the right structure or the institutional framework chosen (Powelson, 1972,5).

According to empirical studies, the variables employed to capture some of the effects of the institutional framework on economic development, on average suggest that, societies that subscribe to private property rights and market allocation of resources grew at a 2.76 per cent rate compared to a 1.10 percent rate in nations in which private property rights are circumscribed and the state intervenes in resource allocation. Furthermore, the calculated compound growth rate of real domestic product per capita for the average nation that has an institutional framework with a high degree of political liberty, civil liberty, and economic liberty is 2.73 per cent per annum. The calculated growth rate for the average nation with an institutional framework in which political rights are proscribed, state rights take predominance over individual rights, private property is circumscribed, and the state intervenes in the resource allocation is 0.91 percent per annum (Scully, 1988, 655).

This means that, societies in which individual freedom and initiative is restricted are less efficient in converting resources into output as the more free societies are. By the term "free society" and individual freedom and initiatives, it is meant that market forces will be at work and every individual economic actor will get the benefit of his or her entrepreneurship and his personal capacity mainly because market information

which as a public good will be available to every one. In other words, with such an institutional environment the problem of asymmetric information will be minimized. This of course will have several repercussions on economic activity.

It has been argued in the previous section that under the existence of asymmetric information and conflicting individual or group utility functions, a set of principal-agent problems such as moral hazard and/or adverse selection emerges in the process of transaction. As it was supported by a set of historical evidences of cross-country studies, it would be naive to expect that a society can achieve either efficiency or equity through comprehensive bargaining among organized interest groups. This is because some groups such as consumers, tax-payers, the unemployed, and the poor do not have either the selective incentives or the small numbers needed to organize, so they would be left out of the bargaining. Based on (t)his premise, Olson concluded that, "there will be no countries that attain symmetrical organization of all groups with a common interest and thereby attain optimal outcomes through comprehensive bargaining" (Olson, 1982, 37).

Depending on the nature of asymmetric information and the cohesiveness of the interests among people, it is expected that different forms of organizations will emerge for collective action in order to maximize jointly defined group interest or utility function over time. In this context, Olson argues that

> "if organizations and collusion for collective action usually emerge only in favorable circumstances and develop strength over time, a stable society will see more organization for collective action as time passes...(With other words), stable societies ...tend to accumulate more collusion and organizations for collective action over time" (Olson, 1982, 40)

Such a group can increase the interest of its members while reducing the efficiency and output of the society by lobbying for legislation and cartelization as a closed, anti-competitive exclusive economic organization. Nevertheless, since special-interest organizations and collusion reduce efficiency and aggregate income, in the long term, they reduce not only the competitive power of national a economy as a whole, but at the same time they make political life more divisive and thus an ungovernable society emerges. This result might emerge from any kind of organized or collective action group's behavior regardless of their initial purpose even if be in the interest of society. For instance, the distinctiveness of Japanese capitalism is coming from the existence of long-term symbiotic relationships in the business enterprise and government- business. Furthermore, to a larger extent, the dominance of this system on the other rival

capitalism of the Anglo-American or the continental European type has been explained in terms of this deep embedded institutional symbiosis. As the post-bubble economic crash deepens further, the same institutions and collective organizations, once established purely for national pride and public interest, are blamed with the argument that they have lost their initial identity and goals and have turned out to be an institutional collusion.

3.5- Institutional Change, Economic Growth and Convergence

Institutional change can be considered to be at the hearth of long-term process of economic development because it provides the missing link between development and growth. In other words, via the process of institutional change, an efficient structural change might take place which might also guarantee long-term growth performance. In this sense, economic development can be defined as a process in which efficient institutional chance takes place in a dynamic manner.

The relationship between economic growth and institutional change, however, is mutual. On the one hand, economic growth triggers change in institutions, and, on the other hand, institutions can profoundly influence the level and rate of economic growth. More specifically, according to our previous analysis in the line of the NIE, by affecting transaction costs and coordination facilities, institutions may hinder or foster economic growth. The choice of appropriate political institutions, rules and policies enhance economic growth. Moreover, "by affecting resource mobility and the incentive for innovation and accumulation, institutions may induce or hinder economic efficiency in the allocation of resources and growth. Institutions may also affect economic growth via their impact of expectations, social norms and preferences" (Stanfield, 1995, 103).

Economic growth, in turn, may also impact institutional change, such as contractual choices, relative importance and character of markets, extent of property rights, relative importance of different constraints, relative positions and power of interest groups and organizations, relative importance of what is done within households and within firms, technological choices, the cost and benefits of internal monitoring, and the degree of internationalization of the economy. Economic growth may render some of the existing institutions, such as norms, rules and policies, redundant and require others to come into existence (Powelson, 1972).

Improved economic opportunities, in turn, may increase mobility of workers, capitalists and merchants both in terms of geography and sectors. Greater mobility, however, may tend to undermine both the efficiency of traditional institutions such as family, clan, and community as a source of information with respect to trustworthiness, reliability, predictability and so on. This requires the establishment of some other formal institutions.

This mutual interaction between economic growth and institutional change take our attention to the problem of "efficiency of institutions" in this dynamic change. It might be argued that under perfectly competitive environments, institutional change is a necessary component for economic growth. But since a perfectly competitive market is a theoretical abstraction rather than the reality, and since institutions evolve and live in an environment surrounded by a set of institutional rigidities, inertia and so forth, institutional change may not take place at the required time, place and sequence in an efficient way.

More over, efficient solutions may not be known, or they may be prevented by the historical forces of a society due to social and historical endowments of the society. This suggests that it is not realistic to argue that what exists is efficient, therefore it exists. Furthermore, even if people realize the inefficiency of institutions, they may not have enough motivation for changing them. This means that, even when existing institutions have no benefit to any one in the society, they might persist. As argued by Akerlof, "economically unprofitable and socially unpleasant customs may persist as a result of a mutually sustaining network of social sanctions when each individual conforms out of fear of loss of reputation from disobedience" (cited in Bardhan, 1989, 1391). As a matter of fact, this self fulfilling prophecy turns out to be collective conservatism especially under the strong influence of path-dependent processes. This analysis suggests that it is possible to have cases where an institution is created "organically" (i.e., unintentional) in order to solve and/or minimize transaction cost and collective action problems, but preserved pragmatically (i.e., on purpose) due to reasons explained here.

On the other hand, even if the benefit of institutional changes are known to be sufficiently larger than those who benefit from it could compensate those who would be hurt by it. For instance,

> "The institutions of interlocking of transactions (i.e., in labor, land and credit markets) has been rationalized as a device to save transaction cost and substitute

for incomplete and non-existent credit and insurance markets. But one should not overlook that such interlocking itself may act as a barrier to ant entry for third parties and be source of additional monopoly power for the dominant partner in such transaction. Personalized interlocking of labor commitments such and credit transactions (involving selective exclusion of others) also divide the workers and emasculate their collective bargaining strength vis-a-vis employers, who use this as an instrument of control over the labor process" (Bardhan, 1989, 1391).

Perhaps, the most important difficulty pertaining to institutional change is related to the identification problem and the nature of desired institution in obtaining agreement between the best available alternatives. Particularly, the uncertainties associated to the process of institutional change in terms of its potential benefits and costs, and distributional implications may hinder institutional change, therefore causing transaction costs of institutional change itself to increase.

Equally important is that progress towards more productive and efficient institutional change might be prevented or blocked also by the beneficiaries of the old institutional setting, particularly if such an institutional change affects the control of surplus by a particular class. This suggests that in order to obtain an efficient institutional change that perpetuate, re-distributive institutional change should also be considered with caution. In the context of institutional changes, an important research question is the possibility of convergence between countries, as a result of this economic and institutional change.

To conclude, Japan as a country is in the process of radical transformations under domestic and external pressures, the paradigm of *convergence* will keep its importance in our argument concerning the future course of the Japanese economy. In order to understand and predict future outcome, recent literature on convergence/divergence paradigm would give us more explanatory strength. As we have discussed in the second chapter, those who are interested in literature on the Japanese development are familiar with the argument in favor of *non-convergence* (or reverse-convergence) hypothesis saying that Japanese capitalism in its essential characteristic will remain unchanged, at least, for two reasons: The firstview maintains that Japanese capitalism need not change in essential ways because it is fundamentally more efficient and/or because it is best able to respond to the societal preferences of the Japanese, which differ from other societies of the Anglo-American kind (Sakakibara, 1997). The second view argues that although Japanese capitalism should also converge,

it will not be possible because of the strength of its embedded institutions and the institutional collusion. At the other end of the spectrum, however, considering her recent crisis, it is being argued that, Japanese capitalism needs to converge, and in fact is converging, to the Anglo-American model.

IV. DEVELOPMENTAL INSTITUTIONS IN JAPAN: A Historical Account

Earlier analysis of Japan's attempts for creating the infrastructure of development in terms of material and social and cultural elements enables us to make the following set of observations on the nature of the government's drive for creating a desired industrial structure.

Its first element was/is the active leadership of the state in the economy. Industrial capitalism and modern techniques of production did not have to be invented in Japan. Instead, what was in the Japanese situation in the mid-nineteenth century was leadership, whether from the public or the private sector to mobilize Japan's domestic resources and to import the new technology.

A second principal characteristic of the government which began to take shape was import substitution. The commercial treaties imposed by the Western powers in 1866 had placed Japanese tariffs under international control and at such a low level that the domestic economy was thrown open for import of Western manufactured productions. As a result between 1867 and 1880 Japan ran a trade deficit in all but two years. The government took the lead in promoting industries that would compete with the imports. The most important product in the import-substitution policy was cotton goods--textiles, threads, yarn—which were imported in large quantities in the Meiji years because of their superiority over domestic handicrafts.

Third, Japan would successively adopt as rapidly as possible the elements of Western technology that would increase its production of technologically sophisticated products. Beginning with cotton textiles, private industry with government support acted decisively in using most advanced English technology. Government support came in the form of financing but probably more important in the form of a favorable institutional environment (for example, commercial codes, the banking system, cartels) for the importation of new technology. As a result, over the next several decades, Japan evolved from being an importer of cotton textiles, to being an exporter, to a successful world competitor with England. In other key industries such as shipbuilding and steel production the Meiji government supported private industry's adoption of the most efficient technology through preferential loans, low taxes, and massive subsidies.

The fourth characteristic of government was the development of exports,

initially handicrafts, tea, and raw silk but moving steadily into more value-added products. This strategy of building an economy through international trade (*boeki rikkoku*) made Japan capable of producing products increasingly competitive in price and quality in international markets.

A fifth principal characteristic was a determination to avoid relying on foreign loans. This decision was the result partly of the leader-desire to avoid dependence on the Western powers and partly of fact that Japan was not considered a good risk.
Based on these observations, one of the most important elements of creating a desired industrial structure was the applied government economic policy that formed the basis of Japan's famous industrial policy.

4.1- Initial "Trials and Errors": Basis of "Learning By Doing" Method

As will be discussed later in this chapter, industrial policy constitutes one of the strong continuities of the Japanese economy. The theme of historical continuity, however, is not closely related to the so called "unique" cultural aspects of the Japanese but, to a large extent, rooted in the political rationality and in institutional innovation. As Johnson says, the industrial policy and its continuity is rooted "...not primarily or exclusively in Japanese culture, vestiges of feudalism, insularity, frugality, the primacy of the social group over the individual, or any other specific characteristic of Japanese society" (Johnson, 1990, 42).

A second note for a starting point is that, the emergence of the industrial policy in Japan was not the result of purposeful activities and the plans of governing élites. Rather it was the by-product of the domestic and external circumstances surrounding the Japanese economy by the end of the 19th and the early 20th century. Moreover, it took shape step by step with many influences, including Tokugawa realist thinking, but we can begin to see in the 1880s the early outlines of its principal characteristics.

Although we have started exploration on the historical records of the economic modernization, especially in terms of its institutions since the Meiji era onward, a progressive scenario of pre-modern Japan is evident in many of the studies. Nakane's contention for the legacy of an earlier period is that "the Tokugawa period was by no means a static feudal era...but was a time of remarkably active development and preparation for subsequent modernization" (Nakane, 1990, 7).

It can be argued that, the static energy of the late Togugawa era was transformed

into a kinetic energy and it was this responsiveness to economic stimuli that made the economy unusual. When exposed to the stimulus of foreign technology and foreign markets, the accelerated growth of the traditional economy made Japan's industrialization possible. During the Meiji Period the growth of agricultural output and the production of traditional industries provided the capital accumulation that could be transferred to the modem sector of the economy by means of the land tax. This growth provided the exports that in turn gave the needed foreign exchange for buying raw material abroad. Moreover, it satisfied the growing demands of the rising population. Therefore, traditional skills, resources, and their products provided the crucial building blocks for the foundation of modern industrial society.

After a decade of direct government investment in mines, railroads, arsenals, and factories, the government realized that the side effect of this direct involvement in economic activity was inflation, trade deficits, corruption, and bankruptcy. As a remedy to this economic malaise, influential leading liberal economists of the time insisted that the government can control the economy provided that state enterprises are privatized, and instead of direct involvement in the economy, the state should sponsor private capitalism in Japan.

According to this new approach, the government began helping private entrepreneurs to accumulate capital and to invest in the field of the required military security and economic development. The Minister of Finance Matsukata, influenced by these suggestions, applied very harsh deflationary policies, and around 1885 Matsukata deflation accomplished its objectives in controlling inflation, eliminating the foreign trade deficit, and eliminating the balance of payments deficits.

The beneficiaries of the new policies, however, were the big merchants such as Mitsui, Mitsubishi, Sumimoto and Yasuda which later came to be known as the zaibatsu. As will be discussed throughout this study, the pro-big policies of the Japan's economic development persisted in the course of Japan's industrial history. In the process of privatization, sponsorship of private entrepreneurs, management of interactions between the government and big business were highly personal, unofficial, and direct, a process lead to the increasing impact of the capitalist class on the nature of economic policies. The Ministry of Commerce and Agriculture (MAC) was established in order to establish the legal frame work for legitimizing these relationships between government and industry, on the one hand, and the unifying all of the government's various economic activities, on the other.

The Ministry of Agriculture and Commerce (MAC, in Japanese, *Noshomu-sho*) was established in 1881. The Ministry of Commerce and Industry (MCI, in Japanese, *Shoko-sho*) was separated from MAC as an independent ministry in 1925. But the reorganization of the MCI into vertical bureaus in order to represent the interest of each strategic industry were created in 1939. At the beginning the interests of agriculture and industry was represented simultaneously in the body of the MAC. But the influence of the agricultural wing dominated the ministry because of the fact that during the early industrialization period Japan heavily depended upon agriculture in terms of subsistence, the source of government revenue and even the foreign exchange via the export of agricultural products, mainly silk that made it possible to control trade deficits.

The story of the Yawata Steel Industry and its impact on ministerial activities reflects the nature of personal, unofficial, and direct processes between government and the private sector. In 1896, MAC was authorized to take responsibility of managing the state owned-and-operated Yawata steel industry. As a result of ministry activities for the Yawata steel industry, it controlled the 82 per cent of the industry in 1901. The priority of the steel industry in the economic development experience of Japan have been so influential that state polices of ministries were increasingly identified with the interest of steel industry. That is why it was said that "steel is the state" and even during 1960s, Ministry of Foreign Trade and Industry (MITI) was called as "Tokyo branch of the Yawata Steel Industry".

Although creation of the Yawata Steel Industry was one of the major achievements of MAC, the inspiration, however, came from the military wing. This means that industrial interests were subordinated to the agriculture because around 1915 Japan was still predominantly an agricultural country. At this time agriculture accounted for 45 percent of the national product, fishing 5 percent, while mining contributed only 5 percent, and manufacturing 44.7 percent. Concerning manufacturing, however, half of it consisted of light industries such as textile and food stuffs till the end of 1930s. Since agriculture provided the major source of growth in the economy, strategic policies were also concentrated on agricultural interests, and industrial affairs were seen according to the principles of free market economy in the early1900s (Johnson, 1992, 87).

The influence of industrial wing on the MAC started with the Yamamoto Tatsuo of Mitsubishi zaibatsu, who was appointed as the minister of MAC in 1913. The impact of the World War I produced significant impact on the Japanese economy and thus on

the structure of the ministries. After the war, there was a significant expansion in the economy between 1915-18 and it was named as the "war boom" during which exports exceeded imports, and therefore the Bank of Japan was able to pay out all of the foreign debts, purchased foreign bonds, and increased country's gold reserves. Under the special circumstances of the war boom period, a new class of wartime riches (*sensou narikin*) emerged.

Parallel to the urbanization and increased industrial activities, demand for and price of agricultural goods, particularly for rice, increased dramatically. This increase in the price of rise was also approved by the government because of, particularly, the pressure of big land-owner class. In turn, this government policy in behalf of the agricultural interests was strongly resisted by the urban industrialists in order to relieve the pressures of wage hikes and to maintain industrial peace. Finally, this rice issue resulted in prices for city dwellers versus rice prices for farmers. During the bad harvest season of 1918 profiteering and rice speculation became one of the acute social problems. The Law of Profiteering Control Ordinance was implemented. This legal ordinance, however, did not produce the desired impact and could not prevent social turmoil during the "rice riots" of the 1918s. With the implementation of the Rice Law in 1920, duties on rice imports were removed, Japanese colonies of Taiwan and Korea were open to rice cultivation, and price controls on rice were continued. This law lead to the further worsening of agriculture and a serious agricultural stagnation emerged.

As the recession of 1920 worsened, the trade deficit increased, the stock exchange market declined dramatically, and both agricultural and industrial output fell drastically. All sectors of the economy were hit by the ten year stagnation of the economy around 1920s. Only war-time rich zaibatsus, however, were able to resist and survive, mainly because of their capabilities to make lobbying activities for interest conforming special procurements via bureaucrats and politicians whom they had supported. On the other hand, there were serious bankruptcies in the small industries and agricultural tenants.

It is accepted that the major cause of this long-lasting recession was the overproduction syndrome in the economy during the war time boom. The possibility of high profit margins attracted massive entries into the market and lead to the serious "destructive competition" around the 1920s. The experience of unrestricted and unregulated excessive competition which resulted in excess capacities can be

considered one of the serious turning points in the history of industrial policies in Japan due to its persisting impact during the rest of the period.

Against this economic bottleneck, most of the time the government response was not appropriate in the sense that the government had relied heavily on trial and error processes rather than pursuing a well-defined and full-fledged policy outlook. During this recession, government's dominate economic policies were still shaped according to the demands of big business.

One of the side effects of the pro-big business policies was the emergence of big "bad debts" around 1927. Moreover, social tension had also increased because of the militant labor movement against government policies. In the later stages of economic stagnation, it was realized that despite the "strategic importance" of big zaibatsus for the economy as a whole, small and medium sized enterprises were also crucial for the economy because they had employed an overwhelming majority of the industrial lobar force. Besides their contribution to the employment figures in the economy, they were also contributing from 50 to 65 percent of all Japan's exports, but with huge losses because they had to dump their products in export markets in order to compete with zaibatsu firms. Further more, because of the established repression and dominance of the zaibatsus in the export markets, and marketing channels, zaibatsus supplied the necessary raw materials to the small enterprises in an expensive way, and bought final export goods in a cheap way. Upon these progresses, the Ministry of Commerce and Industry (MCI) was also established in 1924 in order to represent the interest of agriculture and industry separately.

In order to solve the crisis of the economy resulting from over production and destructive competition between the Japanese firms, the Exporter Association Law and the major Export Industries Association Law were enacted in 1925. Johnson underlines that "in them we see in embryonic form major instruments of policy that the Japanese government has employed to the present day, notably the "recession cartels" and "rationalization" cartels, as they were to be called in the MITI era" (Johnson, 1992, 98).

After the financial panic of the 1927s, a large number of competing banks and enterprises were excluded in order to concentrate the limited sources of the economy in the hands of big business for creating strategic industries. That is, despite this radical turmoil, the interest of big business, that is zaibatsu, were protected. In 1927, the Commerce and Industry Deliberation Council (predecessor of MITI 's the Industrial Structure Council) was established and its representatives were chosen among

influential representatives of the society at every level such as, the business class, university professors, engineers, and so on. Its achievements were sufficient in terms of developments in compilation of industrial statistics, a record level of 30 million yen loans to small and medium sized industries, fostering the amalgamation and mergers of some big business such as Yawata steel with the smaller ones to become Japan Steel, subsidies for export, and collecting trade intelligence information. The most important achievement of the council, however, was the introduction of the concept of "industrial rationalization" (*sangyou gourika*) to the industrial life of Japan. This council was strengthened via other institutions such as the Emergency Industrial Deliberation Council, Temporary Industrial Rationality Bureau (TIRB) in 1930 which lasted until 1937.

The Important Industries Control Law came in 1931 which was severely criticized due to the impact of the military class on the economic policies and the strengthening of the zaibatsu structure against the rest of the society. More precisely, it was argued that as a result of these institutional designs, the aim was to establish a monopoly capitalism or at best a highly concentrated oligopolistic industrial structure with policies of "social and commercial dumping". The term "social dumping" is used to imply the exploitation of labor through wage cuts, reduction in the number of employees, and extended longer wage hours. With the concept of "commercial dumping", on the other hand, unfair trading practices were meant.

One further result of the 1920s recession was the initiation of industrial rationalization established for the years around 1930s in order to replace competition with cooperation (*kyou chou*).The goal of the business activities was declared to lower costs, not to make profit. The president of the MCI, Yoshino, has written his understanding and goal of organizing industry away from competition:

> "Modern industries attained their present development primarily through free competition. However, various evils of the capitalist order are gradually becoming apparent. Holding to absolute freedom will not rescue the industrial world from its present disturbances. Industry needs a plan of comprehensive development and a measure of control. Concerning the idea of control, there are really needs to understand it is common sense" (excerpted in Johnson, 1992, 108).

In this radical systemic shift from a market economy to one of a directly managed economy, historically, the role of the German Historical School, the emergence of Fascism in Europe, and Soviet Five Year Planing should be taken into

account. The Important Industries Control Law of Temporary Industrial Rationalization Bureau(TIRB) in 1931 was replaced and or reinforced by the National General Mobilization Law in 1938 and the Important Industries Association Ordinance of 1941. For the president of the MCI, it was aimed to establish an environment in which "self-control"(*jishu tousei*) would take place, rather than direct government intervention. Accordingly, treaty-like cartel agreements among the enterprises were supported in order to fix level of production, to establish prices, to limit the entries to the industry, and to control marketing for a particular industry rather than establishing direct state control (*kokka tousei*). This hope did not, however, materialize and the increasing impact of military power lead to the direct involvement in economics in the form of a managed economy. The cartels enforcement of the Important Industries Control Law made it hardly inevitable for all members of industries to submit reports concerning their investment and other activities to the government. This application established the foundation of government licensing and an approval authority and of the practice of administrative guidance, which together became the hearth of the post-war industrial policies. In "important industries" chosen so that excess capacity was cut, competition was curtailed and profit margins were restored through cartel agreements. At the end, with the invasion of Manchuria by 1938, the entire economy and the its control shifted to war priorities.

To sum up, the aim of the industrial policies during 1920s was to restore the competitive ability of industry via a set of rationalizations and reorganizations. Another aim was to achieve economies of scale by thanking the advantage of new technological developments and to increase the productivity of labor. These aspect of the industrial policies persistent along the course of managed economy. First, free competition was replaced by an "enforced "self-control" and restricted and coordinated competition. This "self-coordination", however, took place through the government enforced cartel arrangement. Second, instead of profit maximization, managerial and enterprise performance and efficiency was privileged. In this sense, labor peace, job security, cost cutting, capital formation, increased productivity, and the development of new products was stressed. Third, cooperation and coordination between government and industry dominated all of the economic activities.

4.2- The Managed Economy: Towards the Formation of "Developmentalism"

The paradigm of the managed economy in 1931-1945 represented a military version of developmentalism in Japan and this is considered as one of the major departures from the pre-1930 practices. As a response to the Great Depression, Japan chose expansionary militarism for solving economic bottlenecks, and resolving conflictual interests, mainly among the great powers of the Asia. The most important aspect of this era from the view point of the current study is the institutionalization of the economy and its legacy on the nature of economic organization on the post second world war era.

From the very beginning of its industrialization experience, as we have discussed in the introductory chapter, Japan had been under the strong influence of the German Historical School. Its influence around the 1930s, however, was magnified in scope and scale due to emerging circumstances. Having been influenced by the German theory of total war, the ideology of the managed economy resembled the orthodox doctrine of mercantilism, which regards wealth as the essential means of acquiring military power and views military power as an important means of acquiring wealth. To a large extent, it can be argued that this mercantilist response of Japan to the Great Depression was a kind of protective counter measure at that stage of capitalism, a process which resulted in a managed economy with the state as the dominant actor. Ironically, the state played an important role, first in the emergence of a market society from mercantilism and then in the collapse of a market society into fascism and world war. In any case, state intervention, despite having varying degrees and objectives, were shared by all the industrialized countries. The case of the Japanese managed economy between 1930 and 1945 can be reduced to three factors.

First, the economy was endowed with strategic significance. As a response to wide spread market failures, the total war argument of the German Historical School underlined that "..in modern war victory or defeat is determined directly by the strength of industries that make weapons. The state must utilize every economic instrument to devote all available materials and to fight to the last minute in order to survive" (Arisawa, excerpted in Gao, 1997, 24). As the "ends" in the economy are derived not from economic stimulus, but rather formed under the political priorities, this line of reasoning had a profound impact on the institutionalization of the Japanese economic system. As a matter of fact, as we have discussed before, this strategic oriented approach to economic activity has been intact since the Meiji period onwards. It was

argued in the introductory chapter that, the ultimate impetus behind the Meiji restoration was not modernization because Japan believed the in merits and superiority of the Western civilization. Contrary to that, modernization, westernization, or whatever it is called, have been interpreted as a vehicle of "expelling" the western barbarians in order to eliminate their threat on the national independence of Japan. In this context, the economy was privileged in order to create a rich nation with a strong army.

It should also be noted that industrial policy in one form or another goes back to the Meiji era, but it is also true that after the turn of the century the government moved away from its former policies of interference in the domestic economy until the 1920 recession and the resulting successive social turbulence.

The second aspect of a managed economy concerned the coordination and restriction of competition. The reason is that under the influence of German and Italian Fascist movements, the Japanese perception and the response to the Great Depression was different from other major capitalist countries. For the sake of national interests such as economic strength, national independence, and military power, Japanese system tended to reject some of the basic presuppositions of capitalism, economic men (*homo economicus*), individual utility maximization, short term profit motives, and unlimited right of property ownership, and extreme individualism. This attitude towards the new era resulted in far reaching conclusions for the future of the system in the sense that a non-market governance structure replaced the market mechanism as the mode of resource allocation through non market governance structures such as cartels, control associations, and the main bank system. The Important Industry Law in 1931 was enacted in order to ensure that they are "appropriate" for public interests. Once such a license was provided from the state authority, cartels were supported.. Once such a cartel was established, the government also firmly placed pressure over the rest of the firms in the same industry in order to follow the cartel agreements.

According to the Important Industry Association Ordinance, several industries were regulated indirectly by the state but in theory the firms in these controlled industries were managed by private ownership. For instance, these associations had the authority to decide the amount, varieties, and methods of production; terms, prices, partners, and timing of transactions; and profit, dividends, and bonuses. This means that for the sake of national interests, not only the opposed interests of capital and labor were eliminated according to the principles of fascism, but short term economic rationality in allocating scarce resources was also strongly rejected in Japan.

Thirdly, despite such strong bureaucratic control and non market governance structures, due to situational determinants such as resistance from the private sector, a Japanese style of developmentalism under the title of a managed economy could not be converted to a Russian style central planning. The Japanese style managed economy remained situated between direct fascism and absolute communism. It was not so weak or "market friendly" similar to the New Deal in America and it was also not so strong as communism in Russia.

As Noguchi strongly argues, the Japanese system took its dominant form the period 1940 until the end of the second world war. Concerning the restructuring of the economy following a strongly managed economy, the Outline for Establishment of the New Economic System was presented to the country in 1941. One of the most important sources of this plan was the Okocho School. The idea behind this school was to contribute intellectually to the creation of an economic actor appropriate to the priorities of the system. Instead of short-term pleasure seeking and leisure maximization and, therefore, the calculus of individual utility through consumption, a Japanese economic actor should understand the merits of long term oriented collective utility. This view, necessarily, implies that communitarian priorities dominate individual desires and priorities. It was argued by Okocho that, "the enrichment of human life would result from economic growth, and indeed that economic growth provided the only way for life to be enriched. Consumption was equated with evil, and calls for a higher standard of living were considered an indication of laziness"(Noguchi, 1997, 81). In other words, a standard of morality and/or legitimating framework was seen as a necessity for the creation of a public good as a source of an incentive scheme. Philosophically thinking, this idea had a certain degree of rationality in the sense that, "...the standard of proper behavior is not past on through genes. It is highly malleable and comes up in all sorts of different forms in different societies, but some standard of morality is necessary for every social animal..." (Robinson, 1962, 5). In the same vein, Okocho, one of the pioneers of the new economic ethics, suggested that social policy and ethics would have to re-enter the realm of economic life. This is required not in order to constrain economic activity, but to stimulate and accelerate it, and do so without any return to the profit seeking of *homo-economicus* (Koschman, 1998, 8-10).

The New Economic System of the time contained an important policy concerning industrial organization. The policy was to restructure small and medium sized companies in relation to other companies in order to promote productivity. The concrete

form of this the was institutionalization of de facto dual structure of the economy through system of subcontracting. Another dimension of the emerging system is the institutionalization of indirect financing to substitute direct finance which had played the largest role in industrial finance in prewar Japan. The real intention of substituting direct finance with indirect finance was "to alter the loan principle of the financial institutions, giving priority to security, and make them provide sufficient funds for munitions industries with high risk and low profitability" (Tetsuji, 1997, 293). As will be discussed in chapter six, since the introduction of this system several companies have braked away from the control of capital and its emphasis on the pursuit of profit, mainly after the innovation of cross-shareholding system.

4.3- The Developmentalism

Developmentalism refers to a set of national policy principles and organizational arrangements, according to which development of an industry and the fair sharing of its outcomes are seen to be national objectives toward which the entire country should strive. In the context of Japan, Yamaura's definition of developmentalism can be made as the following:

> "Political-economic system in which institutions are shaped by the belief that a developing economy ("catching up") by adopting a wide range of industrial policies that will enable its manufacturing firms to adopt successfully new technology as rapidly as possible in order to increase, over time, their productive capacity and efficiency" (Yamamura, 1997, 296).

This developmentalism is clearly associated with the structural view that in developing economies economic change is inhibited by obstacles, bottlenecks and constraints (Murakami, 1998, 181). The history of developmentalism can be traced back to the late 19th century, when developmentalist regimes promoted economic development through public works, subsidies for infra-structural investment, concessions for developing natural resources and measures favoring industrialization. The fundamental drive behind developmentalism was the vulnerability of most Latin American countries to the external economic and financial fluctuations.

With the outbreak of the Great Depression in the world-economy, nationalistic economic policies were formulated in which state enterprise, planning, regulation, and intervention in markets and import substitution were important elements. This process

was reinforced also during World War II. This perspective was introduced to the literature of development economics by Paul Prebisch. At that time it was widely accepted at least by the proponents of the structural view, that in order to break through the institutional constraints of underdevelopment requires government planning and large scale efforts to industrialize. Efforts should be coordinated and a gradualist approach should be rejected in favor of a "big push".

Empirical testing of developmentalist arguments, however, has not produced a consensus among economists and the cons of such a strict developmentalist approach. One of the most cited criticisms for the kind of developmentalism which heavily relied on planning and inward-orientation with import-substitution is that it neither provided fairness nor alleviated the inequalities as were the major goals of the approach at the beginning. Moreover, as the projectionist policies became permanent therefore preventing the efficient allocation of resources, the result was the lack of a competitive economy. These criticisms, however, were not validated in the context of Japan. It is well known that Japan sustained a very high and fast economic growth for more than ten years and ended up with a highly equitable income distribution. As will be discussed in the final chapter, this "middle income society" argument was further used and the comparative success of Japan's developmental ideology examined. Other than this, the Japanese model was also considered as one of the most successful models in terms of creating a domestic competitive environment and the efficient use of resources, at least, until the end of high growth period. The Neo-structuralist view of developmentalism, on the other hand, left a much greater role to the market.

4.3.1- Elements of the Japanese Developmentalism

a) The Production Orientation: The production orientation is the most important aspect of developmentalism. The principle that production takes priority over all else, accompanied by the idea that increasing production will take care of a slew of other issues. This approach is clearly what was needed in a wartime economy during the 1940s. The dominance of this thinking continued even during the high-growth period following the war. The general consensus in Japanese society at that time was that the enrichment of human life would result from economic growth, and indeed that economic growth provided the only way for life to be enriched. Since the leading players in the economy such as consumers, workers, etc. were repressed, and/or the

order of the dominant preferences were reversed in the Japanese version of capitalism, production orientation became possible and constituted one of the strongest distinctive elements of the Japanese system before, during and after the Second World War era.

According to the text-book variant of capitalism, individuals are motivated by their short term utility maximization if they are consumers, by profit maximization if they are share holders by the highest possible wages and leisure maximization if they are labor owners, and so on. In Japan, however, since the ultimate objective of the economy was defined in terms of politics rather than economics per se, the collective utility at the national level was privileged, an outcome that would be realized after national security, strength, and survival is guaranteed, mainly through the sacrifice of selfish propensities such as high consumption, leisure, and extreme individualism.

According to the production priority system (PPS), the profits of big business and the equal distribution of economic welfare to labor was negated, at least temporarily. Consumption was equated with waste as an evil, and calls for a higher standard of living were considered an indication of laziness. In the case of the production-first principle, it went so far as to be seen as a universal value. "This sort of value meshed neatly with the *"work comes first"* attitude that was part of the company-centered ethic of the postwar period. Few spoke out against the idea of flowing the profits of increased productivity back into the company to make it grow more rather than spreading them around through higher wages. Even labor unions moderated their demands for wage hikes" (Noguchi 1997). As we have discussed before, in terms of production, the German Historical School left a deep impact on the Japanese. For List, the causes of wealth are different and have much greater importance then the wealth itself.

> "The power of producing wealth is infinitely more important than wealth itself...the nation must sacrifice and give up a measure of material property in order to gain culture, skill, and powers of united production; it must sacrifice some present advantages in order to insure to itself future ones...through industrial independence and internal prosperity derived from it the nation obtains the means for successfully carrying on foreign trade and for extending its mercantile marine; it increases its civilization, perfects its institutions internally, and strengthens its external power" (excerpted in Gao, 1997,45).

The reason why the Japanese were influenced heavily by the idea of the German Historical School for the preference of a producer economy was closely related to the early "catch up" drive of the Meiji leaders in order to eliminate the potential of foreign

invasions by means of economic and then military strength. Japan's "anxiety" and feelings of "vulnerability" provided excessive stimulus behind innovation of developmental institutions and implementation of economic policies after the economic crisis of the late 1920s recession and 1930s Great Depression. International conjuncture at that time forced Japan to re-interpret "the end and means paradigm" in economics, and the balance was shifted towards production orientation and communitarian values over individualism. According to the production priorities principle, so called munitions industries were promoted until the 1960s. As Japan became successful in promoting the munitions industry, the national power of production was shifted from the industry level to the entire economy.

b) Strategic View of the Economy: Due to a set of geographic, external, and historical factors, which were explained before, Japanese developmentalism, under the "illumination" of the intellectual support of the German Historical School and its Great philosopher List, regarded the economy as a field of "manipulation" to be engineered by the conscious actions and programs of policy makers so as to change the direction of industrialization. That is, as the process of industrialization was left open to the purposeful collective actions of a country's citizens, policy-makers, bureaucrats, business, and laborers, this necessarily required an infrastructure of "social engineering". This necessity to achieve social consensus over "the ends" of economic activity, as well as "the means" of economic policies became clear during the 1920 recession, as there were deep social conflicts on the applied economic policies.

Japan, as a resource poor country, heavily depended on the importation of foreign goods. The sustainability of this situation, however, requires an industrial infrastructure which would enable Japan to export. For this reason, the "export or die" approach reflects this historical necessity rather than a slogan of the 1950s. After the Second World War, the focus of the munitions industry was shifted, therefore, from war-oriented industries to foreign trade oriented industries, with a special emphasis on high productivity capacity, employment and income generating effect, forming the view point of economies of scale making export possible through reduced costs and increased quality with the passage of time.

The legal framework for industrial rationalization plans should be understood in this framework. The natural implication of the strategy to upgrade the industrial

structure, however, was the active intervention of the state in economic activity in order to change the direction of industry by using the industrial policies.

c) Repressed and Controlled Competition: At the beginning of this chapter, it was observed that the Japanese economy could be interpreted in the line of a "laissez-faire" tradition after the 1890s, when the state realized the drawbacks of direct involvement in economic life. This choice on behalf of a market economy continued until the emergence of excess capacity and an over production syndrome in the economy. The critical perspective to the market mechanism without any control or limitation on the nature of competition came into the agenda until the onset of the Great Depression.

During this period, however, the Japanese had realized that one of the most important causes of the economic crisis during the 1920s resulted from harsh and uncontrolled "destructive" competition in the export industries of Japan. During this recession, big corporations captured the largest share of the export markets at the expense of the small and medium sized enterprises (SME). The SME were selling their products below market values to the big corporations, and sold their products in foreign markets practically dumping their goods. Since their capital stocks were limited they could not continue under these conditions and several dozen of them collapsed one after another due to the fact that over production not only lead to waste of and inefficient allocation of scarce resources, but also it lead to the secular decline in their profitability sometimes even receiving negative capital returns.

Since the SME were the major sources of employment and carried the responsibility of export dynamism of the country, the government concluded that excessive or destructive competition should be eliminated from the system. In order to limit competition and institutionalize self-control and cooperation between the Japanese firms, cartel arrangements and mergers were supported and sometimes cartel agreements were made compulsory with legal coercive power. This avoidance of competition should be controlled and limited in case when losses to the national economy exceed the gains that arise from that competition.

An other important drive behind competition restrictive policies was the belief that the international competitive strength of industry lies in production technology, and "destructive competition" was perceived as harmful to the creation and adoption of technology for industry. Accordingly, the Japanese perceived the heavy-chemical industry among the most strategic industries after the 1930s until the 1960s. For this

reason they combined competition and technology polices together in these strategic industries. As heavy-chemical industry requires huge amount of capital and, in the same way, technological progress requires investment in research and development, firms should be motivated to integrate their resources in order to achieve international competitiveness in a cooperative manner. Unless this cooperation was established, the high cost and great positive externalities would make it unlikely to increase technological competitiveness of industry.

This diagnoses on technology and heavy chemical industry combined with government's intention of establishing a cooperative infrastructure lead to the emergence of non-market governance structures, such as the *keiretsus* and cartels. The role of non-market governance structures as the supplementary device to a pure market mechanism was discussed in the third chapter. It is sufficient to note here that one of the underlying themes of controlling competition is to exclude "outsiders" on behalf of the insiders in order to reduce uncertainty surrounding economic exchange. This point shall be taken as vindicating the Schumpeterian theory on behalf of oligopolistic or monopolistic competition for the creation of technological capacity and fostering real entrepreneurship.

What should be noted here is that, "coordinated competition should not be taken in the meaning that there was no competition in the domestic economy. To put the matter from the Japanese view point, regardless of the laissez faire view of competition, competition in Japan exists, but within the scope defined by the state. Neglecting the disputes on the merit and demerits of the state, it is the capacity of state to define the nature and the scope of competition. In order to understand the repercussions of this "orderly competition" on the contemporary Japanese economy, it is satisfied here to note how the Japanese style competition was designed and perpetuated.

At the initial period of the strategically chosen sectors, they were temporarily sheltered from foreign competition so as to achieve competitive strength via several favorable industrial policies. In order to achieve this competitive strength, however, domestic firms were "guided" by the available facilities at the disposal of the MITI and the MOF. The efficiency of these tools, however, started from the semi-autarchic economy of Japan in terms of heavily regulated trade and financial policies. For instance, export remittance was in the control of MOF, and export and technology licenses were strictly controlled by the MITI. Since Japanese firms were working under the severe capital and technological shortages immediately after the Second World War,

and because these resources were heavily regulated and controlled by state, bureaucratic control and guidance had been successfully pursued. These tools were used in order to "ration" firms according to their credibility in the way of MITI's priorities. MITI's success criteria were productivity enhancement, quality improvement, and market share maximization in foreign markets.

This policy of restrained competition has been criticized from the view point of inefficiency and unfair distribution of the economic welfare. While the developmental state view of Johnson for the Japanese system, the two efficiencies of market rationality and plan rationality were analyzed separately. In plan rationality, emphasis is given to the "effectiveness" of economic policies in obtaining preliminary defined objectives such as international competitiveness and market share maximization. There is no doubt that Japan achieved a miraculous success in terms of these criteria. In terms of unfairness, however, the Japan perspective argues that pro-big polices were supported provided that their interests and the interest of the whole nation corresponds. Provided this, their success and their growth would bring expected satisfaction to all, in terms of income, employment, education, higher quality of environment, health and so forth. Again from the view point of developmental ideology, the concept of national interest in terms of *consumer sovereignty* and *fairness* is seen as a double-edged sword to the Japanese economy.

d) **Profit *versus* Market Share Maximization:** The third important element of Japan's "strategic capitalism" (Calder, 1989) is its negation of profit, and overemphasis on the market share maximization. As criticized by Woronoff;

> "unlike competition for profits, where the fact that your rivals make profit does not preclude your doing equally well, competition for market share is a clear win-lose battle. There are only 100 percent of market share and, if you gain a percent, somebody else must lose a percent. If that somebody else were to lose enough market share, it would completely disappear. With employees bound to their company, few alternative jobs and limited welfare, nobody could afford to lose and everybody had to fight on blindly no matter what the cost" Woronoff (1996, 106).

Such an chronic adherence towards market share maximization lead to the underestimation of profit, which had the society subsidize their performance in foreign markets heavily by imposing higher prices for domestic goods and services they produced. That is why the Japanese have been criticized as the "poor people of a rich country" due to fact of "the social dumping" for the sake of achieving market share. In

this framework, Japanese attached serious importance to the productivity improvement as the source of competitive advantage. In the process of productivity movement, major emphasis was attributed to the role of labor and the contribution of innovations. In Ozaki's words (1991) productivity is closely related to labor because productivity is affected by prices, wages, and distribution. The Japanese management system, characterized by life-time employment, seniority wage system, and company unions, is a kind of non-market governance systems to promote productivity by defining who owns the firm and how rights, responsibilities, benefits, risks, and information are distributed among parties affiliated with the firm (Aoki, 1984).

Not only the labor market, but also financial markets were institutionalized so as to serve the goal of broader industrial polices and productivity movement in the present context. The conflict between productivity improvements and its adverse impact on employment because of its labor saving characteristics was resolved as a result of a mutual compromise between labor and employers. This was an implicit agreement that labor would not resist any technological innovations and thus productivity enhancing achievements if companies should preserve the right of employment and should not lay off workers in order to reduce costs and achieve price competitiveness thereby. That is, the ultimate purpose of promoting productivity was to increase employment. The second aspect of this compromise was that the benefits of productivity improvement should be distributed fairly within the firm. Thirdly, management should also consult with labor on how to promote productivity. The life time employment system fostered the viability of this compromise to a large extent.

Gordon(1985)'s extensive explorations on the labor disputes in Japan shows clearly that, the so called "harmony" between labor and employer is difficult to attribute to Japanese "unique" cultural traditions. It was rather the product of institutional innovations achieved as a result of continuous confrontations between them, which should be considered a temporary "*modus vivendi*". That is, its sustainability and even desirability from the view point of both sides depends on highly restrictive conditions.

On the other hand, Gordon argues that enforced productivity improvement policies of the managed economy between 1930 and 1945 became influential on the productivity movement of the post war period. For instance, the control over human resources composed seven articles in the National General Mobilization Law. In 1941, all Japanese men aged 16 to 40 and all unmarried women aged 16 to 25 were required to register their "occupational ability" with the state. Moreover, labor mobilization was

strictly prohibited, a "livelihood wage" system was applied, activities of the labor union were banned, unions were forced to join the firm-based industrial patriotic associations (Gordon, 1985, 275).

The distinguishing aspect of post-war productivity movements is closely related to export priorities of the industry. As underlined by Gao (1997, 60), by achieving a compromise between labor and employers for the promotion of productivity as a vehicle of international competitiveness, "Japanese companies were able to externalize domestic conflicts between management and labor", and "distributional coalitions" were transformed within the company to a cooperative production coalition in competition with outsiders. As Olson (1982) argues, by resolving the expected conflicts within the corporation, the developmental state of Japan achieved a new stage in creating its corporate capitalism, at the center of which "company men" with absolute loyalty took place.

Concerning the nature and possibilities of Japan's industrial policies, Johnson argues that the "Japanese industrial policy is a reflection of economic nationalism, with nationalism understood to mean giving priority to the interests of one's own nation" (1992, 25) mostly at the expense of others. Three parameters supported Japan's developmental ideology in the post-war period. First, the existence of absolute sovereign nation states as the unit of economic, as well as political analysis in the world economy, which eventually lead to the outbreak of two successive world wars. The second element concerns domestic parameters. In the case of Japan, as Garon(1997) argues, state policies throughout its history of industrialization from the 19th century onward relied heavily on the molding of the Japanese mind by taking advantage of Japan's so called "vulnerability" or "frugality" to the external forces, and thus marshaled nationalistic sentiments in order to create nation-wide support and consensus for production oriented, pro-big business policies with a psychology of national mobilization for a "total war". The third factor was the chance of the established cold-war oriented international order, in which Japan was given a certain degree of "concessions" for its neo-mercantilist policies to be viable. In fact, besides the U.S., Japan was also given a "most favored nation status" even by the General Agreement of Trade and Tariffs (GATT).

By increasing the pace of globalization, despite the fact that nation states preserve their existence as a unit of political analysis, political borders, however, lost their meaning to a large extent. Moreover, in such a global village, the success of a

national- trade oriented economy isolated from outsider's equal treatment and access to the domestic markets- the development model could not be preserved through Japan's national campaign. Finally, in the post-cold war era, the international order also would not allow Japan to apply its orthodox "beggar-thy-neighbor" type policies.

4.3.2- Changes in the System

Despite its strong continuities, Japanese style developmentalism changed its characteristics in the post war era. One of the important signs of this transformation was the strong promotion of exports compared to pre-war period. This underlines the new phase of the Japanese developmentalism from a military version to a trade version. As will be discussed in this chapter, a strong foreign trade orientation of the post-war system can be considered as one of the major elements of consensus between the state, bureaucracy, and the big business. All of the scarce resources of the economy, were directed towards to the priority industries with high export potential.

Despite the persistent emphasis on outward orientation policies, the strategic view of the economy still dominated the industrial policy agenda as the old "grand strategy". Since the Occupation polices prohibited Japan in engaging in war-oriented activities, Japan's historical goal of "rich nation, strong army" changed into "rich nation with strong economy", and thus the foundation of national strength shifted from strong military forces to creation of wealth through economic activities. The motive for relying on export was explained by Prime minister Yoshida Shigeru. He argued that "a defeated nation, by analyzing and exploiting the shifting relations among world powers, could contain the damage incurred in defeat and instead could win the peace" (Pyle, 1996, 21). Since the drive for export is strongly viewed in terms of national survival, Japanese policy makers redefined the nature of Japan's comparative advantages in obtaining an international competitive economy. The notion of comparative advantage had been perceived radically different from the assumptions of comparative advantage, as formulated by Ricardian economics. Contrary to this, the Japanese relied heavily on the potential contribution of technology to the value added in the production process in order to get benefit of international competitiveness in the long run.

From the view point of the strategically oriented orthodox Japanese thinking, they were right in their attribute of such a heavy importance on technology because they believed that the fundamental reason behind their defeat in the Second World War was

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their comparative weakness against their enemies. For that reason, they felt the necessity of creating a strategic comparative advantage by utilizing existing scarce domestic sources, such as the dedicated labor, competent bureaucrats, strongly autonomous state, and external factors such as the support of USA against communist expansion in the Asian Peninsula. Concerning the American factor, it should be added that existing competition between the liberal capitalism of America and communist Russia gave an extra ordinary chance to Japan to maneuver and take the advantages of international order

Parallel to the pace of the reformation process of the Supreme Commander of Allied Powers (SCAP), unlike the pre-war period in which competition was eliminated from the system, in this new era the merits of competition were recognized but still closely "restricted and controlled". Besides the controls on free market competition, the profit principle of an American version was also rejected in the post war period. One rational behind this rejection was the introduction of the Yoshida grand strategy mentioned above. With similar logic to the managed economy between 1931-45, in the post war period the market was still controlled and therefore the strong emphasis on private profit maximization was restricted in order to prevent market forces from scattering the scarce capital supply, to nurture the competitiveness of the Japanese companies in the long term, and to maintain the industrial order during rapid economic growth.

4.4- Occupation Reforms

4.4.1- The Post-war Initial American Perspective on Japan's Reconstruction

After the Japanese government's historical decision for an unconditional surrender specified in the Potsdam Declaration (July 26, 1945) of the allied powers, the occupation began on September, 1945 with the signing of the surrender document on the U.S. battleship Missouri in Tokyo Bay.

America's negative attitude towards Japan was visible from the SCAP policies at that time. Since SCAP accused the Japanese of being solely responsible, they were left alone in coping with these devastating economic problems. The SCAP policy stated that the Allied powers should take no action to assist Japan in maintaining a standard of living higher than that of neighboring Asiatic countries injured by Japanese aggression

since the beginning of the expansionary Japanese imperialism.

According to the Cairo Declaration of 1943, all islands in the Pacific, such as Manchuria, Formosa occupied by Japan since 1914 had to be returned to their earlier owners. The Yalta Agreement of February 1945, declared that Sakhalien and the Kurile Islands would be returned to the Soviet Union. In addition, by the terms of Japan's surrender, a large part of peripheral islands, including Okinawa, were relegated to the trusteeship of the United States. In other words, Japan at the end of the war was shrunk essentially to four main islands of Hokkaido, Honshi, Shikoku, and Kyushu.

During the second world war, Japan lost a dramatic part of her pre-war economic strength. Among the most dramatic, Japan's maritime transport was cut off by the Allied powers, and it had been difficult to obtain raw materials. The adverse impact of American's restrictions on Japan's foreign trade was magnified by the emergence of social and economic disorder. Real GNP per capita in 1946 declined to 55 percent of the 1934-36 level. Related to the loss of territories was the severe restriction of fishing grounds imposed by the Allied Powers. Before the war, Japan was the world's foremost fishing country, with an annual catch of almost one million tons. But the catch declined to 360 thousand tons by 1950. This meant that the amount of damage was approximately equal to the net addition to such national wealth over the decade of 1935 to 1945, leaving the remaining total equivalent to the amount existing in 1935.

Naturally, the damage was quite uneven among different categories of material wealth. The most severely hit were commercial ships. There were six million tons of such ships before the war, and four million tons were built during the war. But 8.6 million tons of them were sunk in the war, leaving approximately 1.5 million tons of which two-thirds required major repairs.

The major damage, other than to plant and equipment losses related to war activities, was in residential houses. It is estimated that 2.1 million units were destroyed through bombing, and in addition 550,000 units were lost through removal and demolition, creating a shortage of 4.5 million units. Those Japanese fighting in the war entered the employment market, willing to Work at lower wage rates than their qualifications warranted. Thus, the net effect of the defeat in the war upon manpower situation could be considered positive from the standpoint of the needed economic reconstruction within the shrunken territory of postwar Japan.

Organizationally, the consequences of the defeat in war subsequent to the extreme strains or the War effort were serious. The normal distribution system was

naturally slow to recover after commandeering for military purposes was terminated and the dire shortage of basic consumers' goods continued in the atmosphere of popular resistance against wartime rationing. A natural consequence was the hoarding of any stocks that promised price rises on the one hand and the mushroom growth of black-market dealers on the other. The obvious, overall consequence were rises in general prices. Subsequent to the unconditional surrender, for the liquidation of wartime contracts and the provisions of retirement grants to the military personnel large lump sum payments were implemented. The best indication of the general price rise was the trend of the official producers' price of rice, which was set on September 18, 1941 at 49.00 yen per *koku* (180 liters). This, however, raised on April 30, 1945 to 92.50 yen per *koku*, and then again raised in March 1946 to 300.00 yen per *koku* (Tsuru, 1993).

The Occupation authorities, headed by General MacArthur were confronted with an economy in total collapse. Considering the situation in the aftermath of the war, Amsden has argued that there is no hope other than suicide for a Japanese once thinking about the future of their country. Considering the existing human and natural stock of Japan, similar to Amsden, Ackerman, an expert on Japan for SCAP, was also very pessimistic. In his 1948 final report on Japan, he described the situation of Japan as follows:

> "The Japan of the next three decades appears likely to have one of two aspects if its Population continues to grow to 100 million or more. It may have a standard of living equivalent to that of 1930-34 if foreign financial assistance is continued indefinitely. It may be "self supporting, but with internal political, economic and social distress and a standard of living gradually approaching the bare subsistence level. Either of these alternatives seems more likely than that of a Japan that will have made itself self supporting at a 1930-34 standard through foreign trade and improved resources utilization" (Tsuru, 1993).

Besides these severe conditions, the surrender conditions would lead to the further destruction of Japan. According to SCAP authorities, the following conditions were to be followed by Japan:

1. All equipment and accessories in 20 shipyards will be dismantled, to the extent that it is not needed for the repair of shipping essential to the occupation.
2. All steel working capacity in excess of 2, 500, 000 tons per year out of the existing capacity of 11,000,000 tons will be eliminated.
3. Half of the coal-burning electric generating plants in Japan to be shutdown.

4.All contact process sulfuric acid plants except that necessary to recover waste gases from zinc, lead, copper and other heavy metal smelters would not be allowed to operate any more.

5. All capacity for producing magnesium and aluminum, except facilities for processing scrap, and all strip mills, rolling mills, extrusion presses, etc., used in finishing magnesium and aluminum was to be stopped.

6. All the Japanese assets in foreign countries, including the Japanese Government, the Emperor and the Imperial Household, and the zaibatsu, would be returned to their initial owners.

7. The bulk of the gold and other precious metals now amassed in Japan should be shipped to the U.S.A, to be held in custody pending decision as to its disposal.

Due to a set of reasons, however, America did not insist on these conditions. Some negative conditions that prevented America from insisting on their implementation were the following: (1) the cost of removing plants and accessories and transportation. (2) Limited usage of these materials in the U.S.. (3) Opponents arguing that de-industrialization of Japan would be a burden on the resources of the U.S.. (4) A weak Japanese economy might be destabilizing not only for the neighboring countries but also for the U.S.. (5) The emerging communist threats in the Asian Peninsula against the U.S.. Considering all of these reservations, the American proposal was revised and then abolished to large extent.

Under the severe conditions of the post-war Japan, without the help of SCAP, the Japanese government could not implement a reform package so as to make the required urgent reforms. Therefore with the passage of time, it became clear that this first occupation policy of punishing Japan was not realistic, particularly when the newly emerging international order was considered. Having realizing the sluggish and ineffectual manner in which the Japanese government was tackling the urgent problem of economic reconstruction, MacArthur urged the Japanese Prime Minister Yoshida in 1947 for the implementation of urgent active economic measures. MacArthur insisted to develop and implement an integrated series of economic and financial controls through the Economic Stabilization Board (ESB).

He also admitted that, it is the responsibility of Japan to pay all the required efforts in the redirecting of its human and natural resources to peaceful living and upon competent public administration of democratic and effective economic controls. Aid to Japan cannot be expected upon a scale sufficiently great to overcome mal-distribution

and inflation within Japan. Outside assistance is contingent upon full utilization of indigenous resources, which is entirely a responsibility of the Japanese Government. (Tsuru, 1993).

4.4.2- Cold-War Era and Reverse Course in American Perspective for Japan

The stage was set by the occupation's reverse course, the determination to promote Japanese economic rehabilitation, and the measures undertaken in 1949 known as the Dodge Line. These draconian measures sought to curb inflation, stabilize the economy, and attract foreign investment. The Japanese bureaucracy created MITI in 1949. In the same year, the Foreign Exchange and Foreign Trade Control Law gave the new ministry its first and most important tool to influence corporate decisions: the power to allocate all foreign exchange. If they were to grow and compete, Japanese firms had to import raw materials and foreign technology. MITI used its new law to influence the growth rate of various industries and their capacity to acquire new technology. Enactment of the Foreign Capital Law in 1950, the next step in constructing the high-growth system, gave MITI the power to limit, and control foreign investment, ownership, and participation in management of business ventures in Japan.

Next, the Ministry of Finance together with MITI established the Japan Development Bank in 1951 with access to a huge investment pool known as the Fiscal Investment and Loan Plan (FILP), which comprised the nation's savings in the postal savings system (PSS). The PSS deserve a short explanation as one of the unique and effective institutional innovation in post-war period. PSS offers higher interest rate compared to commercial banks, and because cross border financial transactions were not free at that time, Japanese had to invest in Japan. Around 1950, at the start of high growth period, postal savings contributed some 40 percent of all investment in Japan's priority industries. The system was a favorite place for individuals to save because their accounts were tax exempt. FILP thus amassed savings four times the size of the world's largest commercial bank. It became a powerful policy tool. Johnson calls it "the single most important financial instrument for Japan's economic development" (Johnson, 1990, 48). MITI used it to provide low cost capital to industries it favored for long-term growth. At the same time the Ministry of Finance was ensuring the availability of capital. By insulating the domestic capital market from the international capital market, it could ration and guide the flow of capital to large firms in industries such as steel,

shipbuilding, automobiles, electronics, and chemicals that were adopting new technology and were central to increasing productivity and exports.

In addition to allocating credit, the government used many other potential tools of industrial policy, including imposing high tariffs to protect industries critical to the growth strategy, establishing import quotas, reforming the tax system to favor growth, and giving direct and indirect subsidies to key industries.

Finally, as soon as the Occupation ended, MITI had the U.S. inspired Anti-Monopoly Law revised and watered down. On September 1st, 1953, the Diet amended the Anti-Monopoly Law so as to relax the Occupation-imposed restrictions on cartels, interlocking directorates, and mergers. To maximize efficient use of resources, MITI preferred to have competition limited to a small number of very large corporations. The Fair Trade Commission's authority to prevent restraint of trade was constantly under attack from MITI. In one of the better-documented cases of collusive behavior that resulted from the changed rules, six Japanese firms manufacturing televisions joined forces, forming a market stabilization group in 1956 to control the domestic price of televisions.

They maintained a high price level in the domestic market while government tariff policy kept the market closed to foreign producers. With high profit margins and an ensured market at home, the industry turned to exports, especially to the U.S. market. Through below-cost exports to the U.S. market, Japanese firms were able to drive most of their competitors out of business. The Japanese government spurred and shaped the development of the television industry through preferential credit allocation via large banks, lax antitrust enforcement, condoning of *de facto* recession cartels, MITI-guided investment coordination, and various forms of non-tariff barriers.

4.4.3- Japan's Response to Reparation

Representative of the independent Japanese efforts for formulating reform ideas for postwar Japan was the report of a "Special Survey Committee" organized in the Foreign Office on the eve of surrender with awareness of its inevitability. Actually, the first meeting of this committee was held on August 16, 1945, a day after the termination of the war. The members of this committee occupied prominent positions in post-Peace-Treaty Japan. These included six presidents of universities, a president of the Japan Science council, a head of the Federation of Economic Associations, a member of

parliament, an editorial writer of a national newspaper and a member of cabinet. A brief summary may be given here, as follows:

1. Especially important from the standpoint of democratization of the economy is the democratization of financial institutions, making them publicly accountable through the participation of representatives of consumers, producers, political parties, etc., in their operation.
2. Zaibatsu (multi-industry semi-monopoly groups) may have to be dissolved. However, they for their part have played in the past certain necessary functions - the functions which a newly democratized government will have to take over.
3. In the strategic sectors, a planning principle should be introduced, and if necessary nationalization of some limited sectors might be relevant.
4. The first step towards democratization of the economy is the modernization of agriculture, a land reform should be realized, and transformation of labor power from farms to manufacturing.
5. Although it is inevitable that Japan will to a large extent depend on foreign trade, in order to minimize the danger of open and excess vulnerability, an energetic development and utilization of Japan's comparative advantages, the rationalization of consumer activities are absolutely necessary.
6. Instead of paying too much emphasis on the policies oriented towards reducing excess population, a new policy outlook should be reconstructed from the viewpoint of developmentalism and progress for the creation of new sources of supply in the long term (For further details, Tsuru, 1993, 12-25).

4.4.4- Major Reforms and Discontinuities

A common point both in the American and the Japanese perspective brought into the agenda was the problem of democratizing the whole economic system and the accountability of the government to the citizens. For this reason, it is fair to argue that post-war reforms were the outcomes of mutually reinforcing domestic and external forces. Three economic reforms of particular importance were land reform, dissolution of the zaibatsu, and labor reform.

a) Land Reform: By the end of the 1940s, almost fifty percent of the agricultural land was tenant. The history of land reform dates back to the late 1930s. The aim of the

government was to promote owner-cultivatorship. For this reason before the SCAP pressure for land reform, in 1945 the Japanese themselves revised the Agricultural Land Adjustment Law, according to which land holding was limited and land tax started to be charged in terms of cash.

Under the guidance of the occupation authorities, the Law for the Special Establishment of Independent Cultivators was enacted in 1946. According to this law, absentee landlordism was abolished, non-cultivating resident landlords were limited, the land of owner-cultivators was limited to three *chobu* (=3 hectares), and the nationalized lands should be sold to tenant farmers. It should be noted that, because of inflation, the real value of land dropped radically. In this sense the Japanese land reform was considered as almost "equivalent to confiscation" (Kosai, 1989, 496).

As a result of the land reform, about 38 percent of the land changed hands. Tenant land was reduced to 10 percent of the total agricultural land. Tenants' rent became negotiable; and tenant disputes disappeared. This motivated the will of work among owners, and political stability in agricultural land was established; agricultural development was achieved through government price supports and infrastructure investment.

After the fragmentation of the tenant system, an explosion of the outflow of the labor force from agriculture towards manufacturing industry in the urban locations took place. This was the initial aim of the fragmentation of the land holdings. There was also a reverse side of the coin, however, because productivity improvement was impeded due to this radical fragmentation.

b) **Labor Reform:** The stability of the labor market was established by the Peace Preservation Law of 1925 that aimed for the preservation and protection of the ideological basis of the so-called national polity (*kokutai*) through the means of various legal pressures such as suppression and persecution. According to this ideological perspective towards labor, only the pro-capital and pro-military oriented labor from organization was allowed and nay modern version of labor unions was strictly prohibited. (Tsuru, 1993, 23).

The aim of the labor reform was to (1) encourage the formation of free trade unions; (2) to abolish of the repressive laws and prohibition of unfair labor practices; (3) freedom of speech, publication, assembly, and (4) finally collective bargaining to be legally approved and an arbitration system for the labor disputes to be created.

In order to achieve these objectives, a set of laws was enacted. At the core of the labor reform three laws have significant importance. With the Labor Union Law of 1945, the right of workers to organize and bargain collectively was accepted. Also this law exempted labor union activity from civil law, and defined unfair labor practices. With the enactment of the Labor Relations Adjustment Law of 1946, the limits of strike behavior and procedures for the settlement of labor disputes were defined. And finally, with the Labor Standards Law of 1947 a set of conditions such as the prohibition of forced labor, the establishment of an 8 hour working day, the limitation of female and minor employment, and the provision of compensation for work-related injuries, were defined.

Upon these legislative procures, labor union activity grew rapidly. As a result of inflation and the worsening of the general economic situation, there were frequent labor disputes. By the turn of the 1950s, the rate of unionization of the industrial work force was over 50 percent. The ongoing struggle between the union leaders for the primacy of political versus economic priorities continued until late 1955s. In this period, American policy towards labor unions cycled according to the changing needs of the occupation forces. For instance, a strike project of the public workers in 1947 was prohibited by the occupation authorities with the claim that such a strike would prevent the Japanese government from implementing the desired radical reforms for the preparation of the economy. With the consolidation of the labor movements on the basis of the Japanese style "company unionism", this dispute was also settled on behalf of the wing supporting economic privileges. In 1955 the so-called "spring offensives" (*shuntou*) were routines for the wage hike negotiations.

c) Dissolution of the Zaibatsu: The aim of the zaibatsu dissolution for the Americans were two-fold:

1. To destroy Japan's militaristic power both psychologically and as a system. It was argued by the Americans that since the narrow domestic market constraint was combined with the unequal distribution of income, this eventually leads to the strong drive for export expansion with imperialistic attitudes. In order to prevent this, excessive concentration of economic power should be eliminated; remnants of the semi-feudalistic monopoly or oligopolistic structures should be liquidated.

2. To enable Japanese workers, who had been exploited by the zaibatsu in the past, to obtain higher wages and salaries, thus expanding the domestic market. (Tsuru, 1993, 19).

By 1947, 83 companies had been designated as holding companies, 28 of them were reorganized as family holding companies, and the rest were allowed to operate as production enterprises after their stock-holdings had been transferred. In 1947, the Anti-Monopoly Law was enacted and this established Japan's Fair Trade Commission. In December 1947, the Law for the Elimination of Excessive Concentration was enacted. Several large enterprises such as The Japan Steel Corporation, Mitsui Mining, Mitsubishi Heavy Industries, Tokyo Shibura electric, and Hitachi Manufacturing were divided into several parts. As a result of a set of dissolution practices, the degree of concentration in the iron and steel, shipbuilding, beer brewing, papermaking, and other industries was substantially reduced.

By the turn of the early 1960s, however, almost all of the major dissolved enterprises re-emerged. Among these, the Mitsubishi Trading Company (1954), the Mitsui trading Company (1959), Mitsubishi Heavy Industries (1964), and the New Japan Steel Corporation (1970), re-emerged after the end of the occupation in the form of Keiretsu conglomerates. Because of the new competitive surrounding and the incentives, industrial firms not affiliated with the pre-war Zaibatsu such as Toyota, Hitachi, and New Japan Steel that had no relationship to the prewar zaibatsu, expanded into large enterprises, thanks to new entry opportunities and the possibility of enlarging scale economies.

The Occupation policies were also very significant first, in preventing Japan's intentions of economic expansion through militarism and imperialism. Second, there fore, instead of allocating scarce resources for military ends, Japan could successfully adhere to the improvements of capital, human resources, and other infrastructures for development under the American "nuclear umbrella". Third, it is the first time that the Japanese were allowed to observe first hand the high American standards of living and efficient industrial organization methods. Fourth, the Occupation brought a chance for Japan to change in Japan's elite domination towards a more open society in terms of democracy and civil society.

To sum up, the American occupation of Japan lasted for six years from September 1945 to April 1952. This period is analyzed in two periods. The first period is characterized with American intention of punishing Japan in order to take the revenge

for Japan's attack on Pearl Harbor during the Pacific War. In the second period, however, there was a radical shift in the U.S. approach to Japan and the restoration policies. The second period was characterized by the U.S. determination to restore Japan's prewar position as the "work shop" of Asia because Americans felt the high cost of revenge.

Not only the deteriorating social and economic situation in Japan but also the general political environment in the world economy forced the Americans to reconsider their policy towards Japan. Among these factors, the rapid deterioration of the Nationalists in China, the worsening of inflationary crisis in Japan, the threat that the international economy would not absorb sufficient export to sustain American prosperity, and increasing tensions between the U.S. and USSR created a new context by 1947 in which the capitalist class and state managers thought about US relations with Japan.

The emerging cold war situation in the world economy strictly forced the Americans to the signing of a treaty not only in order to bring Japan to the American side by a security agreement but also the support on Japan for strategic purposes as well. A set of new situations underlined the nature of increasingly complicated character of the conflictual interest among the United States, the Common wealth countries, the Soviet Union and China. After the fall of Czechoslovakia (1948) and the division of German by the Berlin blockade (1948-49), in Asia there was a rapid expansion of communism, first in China (1949).

Therefore, according to the American policy of "containment" and the "domino doctrine" Japan was brought under the roof of American co-prosperity. The first significant sign of the new American approach was formulated in the "Nine-Point Program" of Joseph Dodge, a Detroit Banker and the personal representative of President Truman. According to (t)his program;

1. A balanced budget should be achieved as soon as possible through the use of all means such as curtailment of expenditures and the maximum expansion of the government revenues.
2. A tax structure should be developed and tax collection should be strengthened by legal measures of severe punishments for evaders.
3. Credit expansion must strictly be limited to the priority industries for the reparation process.
4. An effective program of achieving wage stability should be implemented.

5. The coverage of the existing price control mechanism should be strengthened and if necessary be expanded.
6. Japanese authorities should be delegated to take the necessary measures in order to control foreign trade and foreign exchange.
7. Allocation and rationing of the system in order to maximize export capacity should be improved.
8. The production capacity of manufacturing goods and essential indigenous raw materials should be assured.
9. The efficiency of food collection program should be improved.

This program resembles the 1947 Economic Stabilization Program with the exception of the special emphasis on the balanced budget in the later. Dodge's considerable contribution to the program was his radical decision to implement a single exchange rate. He announced in April 1949 an exchange rate of 360 yen to dollar of the Japanese currency. Having implemented these policies, by the turn of 1950s, a serious economic stagnation appeared that is known as the "Dodge deflation". With a dramatic inflation of 138 percent in 1949 (1948 base year) and dramatically rising unemployment, a series of bankruptcies took place in the small industry. There was an emerging serious social tension for this hard program. The outbreak of the Korean War was considered to be one of the lucky events that became a turning point of Japan in history.

It was because of this cold war situation that forced John Foster Dulles, foreign policy advisory to the secretary of state to declare basic outline of coming peace treaty between Japan and the U.S.. Dulle's declaration in June 1950 underlined the America's future perspective for the role of Japan as far as American interests are considered.

1. Japan should be the part of the free world and be friendly to the U.S.A and should set an example to the rest of Asia as a member of the free world.
2. Western countries should protect Japan from falling into the communist orbit due to her geographical situation and vulnerability.
3. A strong police force must be created to eliminate the potential danger of indirect aggression such as subversion.
4. A progressive reduction of military occupation should be made and occupation reforms should be preserved, and there are to be no reparations or economic restrictions.
5. Parallel to the peace treaty, a security agreement should be concluded.

To conclude with Tsuru's own words, " at any rate, the Treaty of Peace for Japan, albeit a separate one, came into effect on April 1952, and Japan regained her independence. By then, the postwar inflationary trends had been essentially contained, although the Korean War boom was accompanied by a temporary price rise of 38.8 percent in the index of whole sale prices between 1950 and 1951. Industrial production also registered the index level of 131 (1934-34 =100) in the fiscal 1951, over-fulfilling the government target set one year earlier by 40 percent" (Tsuru, 1983, 65).

The general observation on the response of Japan toward American's demand is that, sometimes Japanese cooperated with, and sometimes resisted the American program. It has also a weak empirical support to argue that all the America reparation policies became successful. During the Occupation years, for instance, the policy aimed at promoting economic expansion met with limited success. In analyzing the post-war reforms, the contributions of the Japanese to the process of revival should also be considered. Kosai mentions Arisawa Hiromi's "priority production method" as well as the American initial postwar reparations policy and the 1949 set of policies intended to promote recovery and self-sufficiency recommended by Detroit banker Joseph M. Dodge (Kosai, 1989). It was the Korean War that finally stimulated demand and kick-started high growth.

By the turn of 1950, corporate behavior in Japan was in fact similar to that of the other industrial countries in the sense of putting emphasis on short term allocative efficiency and profit principles. One negative repercussion of this shift form the managed economy bias against profit principle was massive layoffs in order to reduce production costs. Because of the continuous confrontations between labor and capital owners, there was also great resistance to this process from the labor unions. Having realized the high cost of confrontations, particularly during the Miike strike in 1960 when the Mitsui Company intended to lay off more than 6,000 workers in the Mike Coal mine, Japanese policy makers and business leaders realized the necessity of introducing new institutional innovation in order to reach a *modus vivendi.* This new approach to the conflict resolution was stemming from the reality that not only policy makers, but also employers realized that Japan had already entered a new era which requires different attitudes than the one applied during 1930s.Upon this perception, a set of institutional innovations came soon after. In order to establish a continuous and stable supply of "cooperative" labor, much of the big companies recognized the

importance of permanent employment system based on life-time employment, the seniority wage system, and the company-based labor union.

Second, one crucial result of this new attitude towards conflict resolution was that employers, once again, abandone the principal of allocative efficiency (cost-benefit analysis in the short run) and therefore corporations could convince labor to cooperate with them in the process of technological improvements, innovations, and quality controls. This was beneficial to both sides because in this way labor achieved job security and high wages through increased productivity, whereas corporations established a stable labor-capital relation and smooth functioning of productivity increases via technological improvement in the strategically chosen sectors and in the body of big corporations, new movements of production were fostered. The principle goal of the movement was to increase the long term competitiveness of the Japanese strategic industries. The distinguishing aspect of the movement, however, from the rest of the previous institutions was that labor would become an integral part of the movement rather than in a rival position. In order to get this result, allocative efficiency was removed from the policy agenda of the big corporations, and labor unions were included in the decision making process of the corporations concerning productivity measures and export promotions. A final note is that this cooperation became possible, to a large extent, because of state initiatives as the state regarded labor disputes as an issue of "public security".

With the stabilization of conflictual labor movements of the 1950s in the post-1960s era, at least one element of the old zaibatsu was eliminated. That is, traditionally zaibatsu managers were also the holders of the corporations and their primary drive was not to make profit but to gain high prestige in the munitions industries of national priority. With the elimination of zaibatsu by the occupation authorities, zaibatsu families were removed from the managerial posts, and management was finally separated from ownership. This was a significant step towards the convergence of the Japanese corporate system to the American type of management. But still other elements of Japanese "way" retained such as manager-employee joint sovereignty as opposed to the shareholder sovereignty in the West. With the establishment of the indirect financial system, the Japanese entrepreneurs gained the capacity of long term strategic planing and engaging in harsh competition with foreign firms in foreign markets.

Besides the high growth of the 1960s, liberalization attempts, despite under the pressure of international institutions, such as the IMF and GATT, marks another pace of transformation of the Japanese developmentalism. Unlike the Yoshida Doctrine of the 1950s, that relied heavily on political reasons for rearmament and the revision of the constitution, Ikeda Hayato, in contrast, relied on economic objectives such as high growth. All the growth elements and progressive forces were mobilized in order to achieve fast and high growth all over the country and across the industries, not only in the strategically chosen sectors.

4.5- Continuities in the System

Most of the bureaucrats, politicians and technicians who established, implemented and saw the result of industrial policies keep their positions before, during and after the Second World War period. This constituted one of the most strongest continuities of the Japan's economic development after the war. The industrial polices of the 1920s, as a part of developmental state, were the first period of trial and error for the establishment of a full-fledged industrial order after the post second world war period.

Despite the changes that defeat and Occupation brought to the Japanese people, we can see that important characteristics of prewar Japan survived. Leaders such as Yoshida Shigeru were still devoted to the traditional goals of nationalism, although they recognized that these goals must be pursued in different ways. The survival of the bureaucracy as a powerful institution provided an extraordinary measure of the continuity from pre-surrender days.

Many of the characteristics and accomplishments of postwar Japan were rooted in the prewar period, especially in the decade and a half of militarism from 1931 to 1945. Not only was there continuity, but the wartime years left a surprisingly important legacy that contributed to the nation's postwar emergence as a great economic power. From the standpoint of the triumphant emergence of Japanese capitalism in the 1960s and 1970s and its success in catching up with the West, the Pacific War can even be seen as a "useful war." Observing Pyle (1996), the most significant continuities can be summarized as the following.

This wartime legacy has many aspects to the subsequent economic growth. What first catches our attention in this regard is the continuity of personnel and the valuable experience that the bureaucracy which survived the purge, in mobilizing and

managing the wartime economy. The bureaucrats became adept at controlling trade and foreign exchange and guiding the fortunes of key industries. The lessons they learned in long-range planning were of incalculable value in the desperate economic chaos after the war, when they acquired even more power amidst the urgency of rehabilitating the national livelihood.

A second legacy of the militarist period was the industrial structure of the economy. The so called second industrial revolution during the period from 1931 to 1945, when Japan shifted from light to heavy and chemical industrialization in building its military production, hastened Japan's postwar emergence as an economic leader in chemicals and heavy industry. Moreover, the second industrial revolution was accomplished through the formation of a network of small enterprises that served the needs of large companies. Production of parts was farmed out to subcontractors to hasten production increases. Tens of thousands of these small- and medium-sized firms sprang up, forging links with large parent companies; and they constituted much of the flexibility, resilience and dynamism of postwar expansion. In the 1960s, for example, more than 40 percent of the subcontractors supplying parts to Toyota traced the origins of their links with the auto-maker to the war years.

The third useful legacy of the wartime economic experience was the mastery of new skills and technologies by a rapidly expanded workforce to meet the needs of military production. Nearly 4 million new workers entered the industrial labor force during the fifteen-year period. Also from 1935 to 1945 the number of technical schools grew from 11 to 400. Engineers trained for providing the means of war now turned their skills to peacetime industry.

Fourth, nationalism and the desire to catch up with the West persisted in the postwar period, but efforts now focused on economic and industrial goals. For example, machine gun factories were converted to make sewing machines; optical weapons factories now produced cameras and binoculars. One diplomat reminisced in 1979: "The [mighty battleship] *Yamato* and [the fighter planes known as] Zeros-forerunners of the postwar Japanese technology were still very much alive, so it is said among us Japanese, in mammoth tankers, excellent automotive engines, etc. which Japan turns out by the thousands and millions. They have served our nation in a manner never foreseen in their heyday.

Since the early days of the Meiji Period, Japanese leaders had shaped the nation's values and institutions to achieve the goal of catching up with the advanced industrial

nations. *Fukoku-kyohei*, or a wealthy country and a strong army, industry and empire, were the objectives. The postwar conservatives revived the end purpose of achieving national power, but they focused sharply on economic means.

4.6- Conclusion

Having observed from the historical view point, it can be argued that the process of the Japanese policy making can be explained, to a significant extent, within a "impact-response" paradigm. That is, although there have been several references to the "unique features" of the Japanese system, in the course of Japan's industrialization, however, the primary motivating stimulus came from external factors and, in turn, Japan's highly successful response and adjustment, despite in an astonishingly different way.

The Japanese system, as it is called developmentalism in this study, was, more or less, in a similar structure to that of the free market economy, provided that we retain a significant place for " the Japan residual" which suggests that prevailing differences between Japanese and other systems should be attributed to the Japan's unique conditions.

The Great Depression as combined with the war oriented privileges, gave way to the divergence. Third, in the post-war period, under the guidance of international institutions such as GATT and IMF in the protection of pax-Americana, the world experienced a free trade period. Even in this period, taking the advantages of the established world system, Japan successfully transformed its managed economy version of developmentalism to one based on foreign trade. Despite the fact that the Japanese adjustment or response was to a large extent in the same direction with the dominant trends, this response also continued "the Japan residual" such as productivity movement, coordinated and directed competition, and under-valued profit principle. Any way, the Japanese system converged to the western model after the post-war reformation period until the 1970s. In this stage of Japan's developmentalism, two major factors were in operation. As Japan recorded a miraculous economic growth, this achievement gave the Japanese very strong self-confidence and also helped consolidate Japanese institutional innovations as the determining and persistent characteristics of Japan's model. This model, Human Capitalism, so to call with Ozaki's (1991) words, was perceived as superior (Vogel, 1979) and even alternative to the American capitalism (Sakakibara, 1993). Among others, Noguchi (1998) argues that elements of

the present system which lead to "reverse convergence" , in fact, are nothing other than the elements of the war-time practices of 1940-45.

The second element which lead Japan to diverge was the emerging "new" external threats, as Japanese perceived. The emergence of trade and financial liberalization, the collapse of the Bretton Woods system, two successive oil crises in the decade of 1970s gave a strong pessimism and their of feelings of vulnerability and frugality came back once again. Although it was argued that Japan successfully adjusted to all of these shocks, this adjustment, however, was different from the major industrialized countries, and even lead to a new national mobilization feelings (Garon, 1997; Akao, 1983). The nature of Japan's adjustment and its inherent contradictions for the emergence of the bubble economy will be discussed in chapter eight and nine. It is sufficient to note here that after this process the keiretsu structure became much more dominant in the economy, the famous "company men" even became a much more explicit and significant aspect of corporate capitalism, and Japan entered a new stage of industrial dualism because of state sponsored cartel structures, particularly in the manufacturing industry.

V- DEVELOPMENTALISM IN PRACTICE: Industrial Policies, 1945-1980

As we have discussed in the previous chapter, the Japanese developmental ideology in the post-war period was based on the production priorities in order to achieve fast growth, which would generate sufficient employment and income. It was believed that in order to reach these targets, an industrial structure must be created with private ownership but under the public "management" in the sense of direct and indirect guidance so as to achieve maximum performance in international trade. Therefore, the developmentalist ideology has been identified increasingly by the institutions of maximum saving, investment, and export. In order to create the domestic winners and champions in the world league, particularly for the strategically chosen sectors, domestic market of the post-war system was sheltered from foreign competition and organization of economic activity was left to the guidance, control and discretion of the triple compromise between the iron triangle of bureaucrats, big-business, and politicians.

A set of available domestic and external factors supported the achievement of the systemic targets. Among these, Japan's late comer status has not only introduced Japan to a clear cut target of "catch up" of the forerunners and to close the development gap, but also it enabled Japan to take advantage of being a "late comer" in terms of the learning curve effect (or learning by doing) without paying its costs. Therefore, concentrated efforts of the above mentioned systemic coalition has been very fast, effective and dynamic in achieving clearly set targets along explicitly defined methods of obtaining them.

Until the out-break of a set of external crisis such as the collapse of the Bretton Wood System, two successive oil crises, and trade and financial liberalization movement of the late 1970s, this system achieved its *ex-ante* defined targets such as international competitive strength, market share maximization of the big Japanese corporations, employment and income generation, high per capita GNP, its equal and equitable distribution among people and so forth, the Japanese system achieved its major targets. The success of Japan during this period, however, has been increasingly defined in terms of Japan's industrial policies. Therefore, in this chapter the basic nature, institutions and achievements of industrial policies will be discussed.

5.1- Theoretical Justification of Industrial Policies

Theoretical justification of industrial policy rests on the existence of wide spread market failures. In this sense, the emergence of industrial policy in Japan, as being argued, was simply a spontaneous response to the wide-range market failures during 1940s. As we have discussed in this chapter, however, the industrial policies of Japan date back to the emergence of long-lasting recessions first during 1920s, and then after the out break of the Great Depression in the world economy. As we have also discussed before, the nature of industrial policy in the post war period has been different than the one that was applied during managed economy period. That is, post war policies were much more "market conforming" or "market friendly". For the convenience, therefore, in the following section a brief criticism of classical economic assumptions for comparative advantage, competitiveness, and international trade will be presented.

One of the basic principles of the Smith-Ricardo tradition suggests that what nations produce is based on their resource endowment. Nations specialize according to their comparative advantages. Since in the neoclassical tradition institutions and technology are assumed as given, government should not be concerned with the nature of the nation's industry and that, in any case, bureaucrats can never do anything except price losers. What is, then, the legitimating ground for industrial policy?

The implicit philosophical thinking behind neoclassical arguments is the notion that all industries had roughly the same economic and strategic value. Prestowitz says that the Japanese have two difficulties with this theory: It is 'static' and implies certain permanency about the economic activity of nations; and the Japanese believe that some industries are more important than others according to their "security" concept. In his words,

> "Japanese view of economics in terms of "strategic" priorities is in stark contrast to the view held by American neo-classical economists. American view simply says that "Potato chips, computer chips; what is the difference? They're all chips" (Prestowitz, 1993, ix).

That is to say, an acceptance of mainstream economic theories would mean a permanent lap and a kind of colonial relationship that is clearly unacceptable to the Japanese in the age of sovereignty fight between nation states. The reason is clear: "The only surplus that the Japanese economy enjoyed was labor and if Japan had followed

the accepted classical doctrines, it would have produced prewar manufactures like textiles, and toys in which they have a comparative advantage " (Wilson, 1985, 56)

In the spring of 1945, as the last months of the war were unfolding, Okita, postwar Japan's leading economic planner, visited an engineering professor at the Tokyo Imperial University. The two, knowing the war was lost, fell to talking about the lessons learned and Japan's postwar prospects. The engineer recorded in his diary that

> "Okita felt that not all was lost if Japan drew the proper lesson from its tragic experience, namely that "Japan, poorly endowed with natural resources, must shape its future around developing precision engineering." In other words, Okita believed that Japan must concentrate its energies on taking imported resources and fashioning them in the high-quality products for export... He told me this story from around 1882, in which an Englishman used to tell as a warning to the people of this time. A poor warrior wanted to buy a splendid suit of armor but had no money, so he cut down on the amount of food he ate and little by little saved enough to buy a fine suit of armor. A war broke out and courageously he went to fight but because his body had become so weak from his years of semi-starvation, he could not bear the weight of his armor and was soon slain by the enemy. This was just what happened to Japan. He did not think that a defeated Japan would be allowed to rearm at all, but this would probably be a blessing in disguise. Japan did not have the qualities of a first-class power, but she could excel as a second-class power. I completely agreed with all he said. I will actually be happy if rearmament is completely prohibited. An army in uniform is not only sort of army. Scientific technology and fighting spirit under a business suit will be our underground army." (Pyle, 1996, 243)

This passage and our earlier analysis on the historical account of Japan's industrial policies show, whatever the name is given to economic polices pursued in Japan, they are the persistent feature of the way Japan perceived itself, and its position toward the external world. That is, the "rich country, strong army" slogan of the late 19th century Japan persisted along its history without even a small change.

On the other hand, some other scholars of Japan prefer to justify Japan's industrial policy within the framework of Schumpeterian paradigm (Martinelli and Smelser, 1990, 18). As Polanyi (1944) showed in an elegant way, capitalism is an evolutionary process in which competition takes place around innovations by dominant firms and creates monopolies. The important factor is, however, not price competition or resource endowments but the competition arising from new technologies, new sources of supply, and new types of organizations. It is this Schumpeterian dynamic competition based on factors other than price that suggests the legitimacy of government intervention to catch up the others through high level of research and development (R & D) activities (Clark, 1985, 117).

Under the worst experience of a devastating war, in order to help markets to function, accelerate economic development, to rise standard of living, there was renewed interest for development economics. In the same context, empirical evidences supported legitimacy of protective measures. The protectionism at this juncture was based on the classical "infant industry argument. As pioneered by A. Lewis, G. Myrdal, and P. Prebisch, these arguments rest on the existence of external economies and factor-price differentials, which in turn gave rise to "domestic distortions", that is divergence between market prices and opportunity costs.

The theory of domestic distortions deals with various distortions that prevent market from achieving Pareto Optimality. The main proposition of the theory of domestic distortions is that policy intervention must take place at the exact point at which distortion occurs. The theory of domestic distortions is not developed for the justification of protectionism. Domestic distortions are classified into, first, endogenous distortions due to market imperfections such as, external economies, monopolistic and/or oligopolistic market structures; second, policy-induced distortions resulting from economic policies, such as tariffs, production subsidies, and consumption taxes. The appropriate policy intervention is formulated at four main points through taxes and subsidies: 1- international trade through export and import subsidies, 2- domestic production through production taxes and subsidies, 3- domestic consumption through consumption taxes and subsidies, and 4- factor employment through taxes and subsidies on factor use.

A careful observation makes it clear that although the theory of domestic distortions does not legitimize any policy intervention for protectionism, it, however, can be used as a good legitimizing framework for an industrial policy. For instance, in the existence of (positive) externalities, the spill over effect of, say, any technological innovation will prevent innovative firms in devoting sufficient resources for research and development unless the externalities are internalized or losses of innovative firm are compensated via temporary public sector subsidies sufficient to alleviate domestic distortion.

What should be underlined, however, is that the source of this distortion is domestic, and therefore optimal policy intervention is not protection but an industrial policy in order to channel scarce resources into their "effective" uses, that is strategically chosen industries. The process of applying industrial policy is complicated. One complicating factor is identification problem of those activities generating

externalities. Second is related how to determine optimal degree of subsidy. Third, sometimes it may not be possible to prevent spill over effect by applying optimal intervention to the foreign firms. Concerning the final problem, the theory of optimal tariff protection has been developed in order to avoid so-called problems of foreign distortions, that is distortions in international markets.

5.1.1- Infant-Industry Argument for Protectionism

The infant-industry argument relies on temporary protection to correct a distortion that disappears gradually with the passage of time. One of the well-known pioneers of the infant industry argument is John Stuart Mill (1904), who argued that the test for infant-industry protection is whether the infant will eventually overcome its historical handicap and grow up to compete effectively without protection against earlier starters.

The so called "historical handicap" is related to situations in which protected sectors would demand further protection "beyond the time necessary for a fair trial of what they are capable of accomplishing" (Mill, 1904, 403). The possibility that protected sectors might insist on further protectionism is one of the serious "paradoxes of protectionism, because protecting an industry does no good unless the protection itself helps make industry competitive. In this case, protection tuns out to be "pseudo infant industry" (Krugman and Obstfield, 1997, 255). Mill's vote in behalf of infant-industry argument was further refined by Bastable and Johnson. They argued that the infant-industry protection bears a very high burden on the society during the period of learning and therefore these protected industries should have a potential capacity of generating sufficient savings in the future in terms of cost reductions in order to compensate the economy for initial period' losses. In other words, the infant-industry argument requires that present discount value of future benefits be at least as high as initial cost incurred to help infants to grow (Chacholiades, 1990, 180).

To sum-up, for an optimal infant-industry protection to take place, and it should take place during the initial stage of its development and should have high propensity of learning-curve effect. The second aspect has a very important implication due to the fact that an infant-industry undergoes a dynamic learning process that generates external economies over a certain period of time and thus calls for only temporary government intervention.

Within the boundaries of development economics, however, the infant-industry argument was extended to a whole economy. The reasoning is that external economies generated by firms in one industry are not confined to that particular industry but instead are spread over the whole "infant manufacturing sector ". That is why they put their choice for "infant-economy protection" rather than "infant-industry protection" (Chockhaliades, 1990, 179).

Another strong reason for the infant-industry argument is the so-called imperfections in capital markets. According to this argument, if financial institutions such as efficient stock markets and banks in a developing county have not been developed enough so as to channel savings to the potentially promising manufacturing sectors, protection of new industries can be justified as the second-best policy option in order to compensate the initial disadvantage of low profit (Krugman and Obstfeld, 1997, 256).

5.1.2-Trade and Industrial Policy

It is being argued that trade policy can be used to tilt the terms of oligopolistic competition in favor of domestic firms in the hope of shifting considerable monopoly profits from foreigners to domestic industry. The Brander-Spencer argument for trade policy is known as the Strategic Trade Policy (STP). STP was legitimized due to existence of large economies of scale. In order to get advantage of this large-scale investment to the domestic firms, a country can support domestic firms through a production subsidy, a strategic advantage to producer (Krugman and Obstfeld, 1997, 255).

By the concept of industrial policy it is meant any policy that is implemented in order to intervene to and change direction of resource allocation across industries or sectors, or to the organization of an industry or sector in order to achieve economic (and sometimes non-economic) goals of a country. This definition is not, however, a full-fledged, precise definition. For the sake of simplicity, an industrial policy can be dealt on two grounds. The first is related to strategic policies that were designed to promote certain sectors in order to promote domestic industry and strengthen international competitiveness of these chosen sectors. Second, corrective policies that were implemented in order to improve economic efficiency by correcting market failures. Strategic polices are more prominent in case of externalities and where monopolies are

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high. Externalities might create economies of scale, for instance, in the existence of which traditional infant-industry argument becomes much more necessary.

Critics of this approach point out that it is difficult to identify and measure externalities. In the age of global indivisibility, however, corrective measures such as support of research and development activities of private firms and policies to assist structural adjustment of firms to the domestic and external changes seems to be much more credible industrial policy. In case of any sectoral shifts, the primary goal of industrial policies should be to change the direction of productive resources to the emerging sectors, on the one hand, and preventing production factors to remain in the falling sectors.

The Strategic trade policy argument is also criticized on several grounds. First, the effectiveness of trade policy depends on and limited by the availability of the chosen oligopoly model because there is no possibility of knowing how oligopolies behave. That is why we have several models purport to explain oligopoly behavior.

Second, in the case of free entry possibility to a sufficiently large market, dueof high competition the monopoly profit would be eliminated. In that case, instead of generating excess returns for domestic producers, a subsidy may be passed on to foreign the form of lower prices.

Third, the final implication of trade policy should also consider its impact of the efficiency of resource allocation because as a result of targeting of a specific industry, resources will move to this industry away from other untargeted industries that put them at a strategic disadvantage. The expected excess return may be off set by losses generated elsewhere in the economy.

Fourth, it may not be viable to make "correct" targeting in deciding which industry to be chosen, and subsidizing all of them would mean subsidizing none of them, meaning waste of resources.

Fifth, since trade policy entails the "beggar-thy-neighbor" policy that tends to increase domestic firm's income and social welfare at the expense of foreigners, like tariff imposition, strategic trade policy might provoke retaliation.

Based on this theoretical analysis, industrial polices, their major institution, and their overall assessment will be provided. The critical perspective on the nature of industrial policies, however, will be provided in the final chapter.

5.2- Industrial Policies Between 1945-1960

Between 1945 and 1960 Japan was in a period of reconstruction than the devastating damage of the war. In 1946, production index was one fifth of the prewar peak, and one-quarter of the national had been lost during the war. Considering also other restrictions of the allied forces, Japan's first response was in the form of continuing pre-war direct regulations and controls. The industrial policy outlook of Japan can be best reflected in the institutional reforms of the time.

5.2-1- The Government-Industry Relations

As the proponents of industrial policy argue, Japan has succeeded in implementing industrial policy while maintaining a highly competitive free-enterprise economic system (Nacht, 1990, 25). For them, Japanese firms are among the most independent in the world but at the same time they seem to follow the guidance of the government voluntarily:

> "The relationships are 'mutual' but there is 'asymmetric' dependence at the same time. Each Player's (firm) room for decisional mancoure on an issue is constrained by the material and intellectual resources available to him. The characteristic of this relationship is related to their understanding of the 'intervention'. That is, industry expects government to approach it and initiate, while government does not demarcate the public and private spheres in the fashion which is assumed by the western notion of intervention" (Wilks and Wright, 1989, 5).

This is a 'collaboration' exposed above between government and the businessmen. Nevertheless, it was not because they are patriotic or typically Japanese, but because they believe that such a collaboration can be of material benefit, since they are also motivated by profit, as it is all over the world. Since at the center of industrial policies and their implementations, MITI's role was crucial, and therefore, a short explanation on MITI is required.

5.2.2- The Ministry of International Trade and Industry (MITI)

MITI is one of the most important institutions of Japan's post war development history. MITI was established in 1949 as the successor to the post war Ministry of Commerce

And Industry. This change symbolized a shift from a domestically oriented industrial policy, whose main objective was the maximum production of basic commodities, to a policy oriented towards international markets, promotion of trade, restructuring and modernization of industry.

The council of MITI members were chosen among leaders in business, consumer groups, labor unions, academia, government and the press, which empowered MITI with strong social credibility and consensus. Although MITI is important due to its function in the formulation of *consensus management*, its precise weight within the state apparatus is difficult to determine and has changed over time. MITI's aim was forecasting emerging industries, providing information that helps industry to adjust to the market environment, and coordinating industrial activities. In performing these functions the state provided MITI the necessary tools Among the most important tools at the disposal of MITI was foreign exchange reserves, credit rationing, tax exemptions, subsidies and so forth. As a result, industries under MITI control are well endowed with financial resources, and they need some initiations and leadership. They, in response, were expected to behave in an appropriate way to the signals and guidance of the MITI. Though MITI and other ministries are involved in implementing industrial policy, they don't, however, dictate term or impose a central plan in general. Japanese businessmen cooperate with government officials in implementing industrial policy, for they understand that in the long-run it will serve their best interest.

Despite the observation that there is no consensus among the scholars whether bureaucrats were conscious or "omnipotent" in deciding which industry to be chosen, in the process of choosing the "winners", MITI emphasized on several criteria. These were, mainly, growth potential of the industry, income elasticity of demand, contribution to the employment, high technology content in which costs decline rapidly as the scale of production increases. In order to protect and promote these strategically chosen industries, as was explained before, MITI still used trade protection, tax advantages, and subsidies in various forms.

This point should be elaborated a little because there is a deep disagreement between neo-classical assumptions and the Japanese "strategic thinking" for and against "targeting". Neoclassical economics is based on the assumption of increasing marginal cost. In theory, the market can efficiently allocate resources and achieve equilibrium only when the marginal cost increases. As have been illustrated by Romer (1986) and Lucas (1988), production has been characterized by decreasing marginal cost, which has

been sustained not only by the economy of scale, but also by technological innovation. Second, it is important to promote industries that have "ripple" effects on other sectors of the economy such as semiconductors and computers. As the final element in "picking the winners", industries that lead to further increases in knowledge were favored (Prestowitz, 1988, 129). In these targeted industries, we can observe four stages of creating strategic industries.

In the first stage, industries were targeted in which labor productivity is expected to increase rapidly. Technology was selected that could be quickly adopted from abroad, and products were manufactured for markets that were expected to grow significantly. The second stage experienced the consolidation of internal developments between 1950-60. In this stage, expansion among the various producers was carefully coordinated. The Japan Development Bank and Long-Term Credit Bank provided low cost loans. Cartels were established to promote orderly markets. Standardization and specialization of parts realized, cost reduced, quality improvements were stressed and export sales were coordinated to "restrain excessive competition" In the third stage, a simply special sectoral program was launched for a limited number of industries whose development and adoption is of particular importance to the national economy. The fourth stage was the final phase of the process in which new strategic industries were created.

5.2.3- The Use of Industrial Policy Instruments

In order to understand the rational behind limited government assistance with the possible problems that may associated to an extensive or massive government intervention there were several policies. The dilemma of policy intervention emerges when an industry grows stronger as a result of favorable intervention, inevitably starts to drift away from intervention and government becomes coercive and unless a new relationship was created, the intervention was no longer lasting or effective (Aoki, 1984, 05).

Another major reason why Japan can effectively target limited assistance is that government preferred tax incentives rather than direct government grants or contracts. The Japanese rely upon tax exemptions because "a tax advantage is valuable only after an enterprise has done what the government wants it to do, whereas a subsidy is paid

prior to performance and sometimes does not produce any improvement in performance "(Prestowitz, 1993, 125).

It should also be noted that the rationale for government intervention might evaporate as time goes on. Since the government policy is problem solving and if a problem is easily and quickly solved by the private sector or through negotiations, there is no obvious jurisdictional need for the government intervention, thus. In that case, although several deficiencies are associated with it, Ronald Coase's theorem, argues that civil society can solve problems without government intervention provided that property rights are well-defined. (cited in Mutlu, 1991, 347).

Despite the argument that government provided limited support to the "strategically chosen sector" still because of these direct or indirect support and protection of government, Japan's industrial policies have been accused of being the type of "beggar-thy-neighbor" which entails retaliation. The counter argument for this is as the following: The view that private industry in Japan enjoys unfair advantages in international competition because of subsidized loans, large R & D grants from the government, preferential tax treatments or protectionist import controls do not properly reflect the present day realities. One of the primary reasons Japan has been able to reduce greatly the level of trade protection and direct industry subsidies is the effectiveness with which the government can apply guidance and assistance. On the other hand, MITI officials do not meekly acquiesce to government dictates, but they know that "when the time comes to request licenses, permits, choice locations and tax breaks, MITI will respond more favorably to cooperate than to uncooperative companies.

Moreover, the proponents of industrial policy mention also the role of government supports with respect to "timing" and "product life cycles" were important aspect of industrial policies. The argument is that policies of the initial stage, the mature stage, products reache a stable character with increasing market share, and, were dynamic, that is changing according to the domestic, external, and product needs. For instance, this government support in the initial stage when the industry is new and growing, takes the form of granting subsidies for research and development, of establishing joint development efforts among competing firms within an industry, providing technical assistance and advice about financing, foreign exchange, and technology transfer (for the nature of Japan's comparative advantage see, Kellman and Landau, 1984). Wilson argues that "such a phasing of government assistance ensures

that no industry becomes dependent upon continued support, because it maximizes the benefits of an industrial policy that carefully limits and targets government assistance."(Wilson, 1985, 67).

In the post-bubble economy, however, Japan's industrial policies and the related bureaucratic mind-set have been criticized. The criticism is that in the declining stage when the industry faces increased competition from abroad and is losing its comparative advantage, Japan did not expose its "sacred cows", that is traditional industries of the high-growth era, to the international competition. A process, is being argued that, has resulted in the "hollowing-out" of Japan's industry (Ozawa, 1996).

Postponing the critical perspective on industrial policies to the later stages, it should be noted that despite these government supports towards industry and isolation from external competition, the government could foster highly efficient domestic competition, as well as coordinate, when necessary control, and even restrict competition. This should be considered one of the significant successes of government in institutionalizing domestic competition in the absence of or relative autarchy of economy. The destructive consequences of "the uncontrolled competition" of the 1920s were explained when we have discussed the formation of industrial policy in Japan.

This experience not only gave way to the emergence of "managed economy" in the post-great depression period, but it also left its hand print unchanged in the minds of Japan's policy makers even after the Second World War era. Since excessive or destructive competition would lead to the emergence of excessive capacity and overproduction. This, in turn, would cause loss of profitability, waste of resources, bankrupt of several firms, and loss of employment. As we have discussed under the title of Japan's developmental ideology, even the possibility of such a situation would not be acceptable in Japan. Therefore, MITI controlled and fostered "orderly" competition according to the criteria of "market share" each firm has reached. That is, firms were supported by financial assistants according to their market share in foreign market, which should be seen as a guarantee for controlling excess capacity. The other measure of preventing this destructive competition was the use of public assistance in the formation of cartels and mergers in order to reduce excessive competition, and prevent excess capacity.

As a response to the liberalization movements around the 1960s, however, public authorities started propagating a new stage of "nationalism". The reason was that, it was the first time that Japan felt liberal trade and financial systems as a serious

challenge to Japan's traditional paradigm based on "the sovereignty of nations", going back to the German Historical School of the 19th century. As the pioneer of this "mind making" process, the bureaucracy intended to create some additional counter-protective measures in order to by-pass the "harmful" effects of foreign competition on the domestic economy. MITI, therefore, proposed The Law on the Extraordinary Measures for the Promotion of Specific Manufacturing Industries in 1962. This law, however, was not enacted because of the strong opposition of the private sector as they realized the intention of MITI for further and direct control on the private sphere with the same logic of direct intervention to the allocation of resources.

This strain between government and the private sector might be considered as one of the turning points in the history of Japanese industrial policy due to fact that, combined with rising foreign pressures, an appropriate surrounding for "market conforming / friendly" system started rising. That is why, the industrial policy of Japan has been called as "administrative guidance" in the later era. According to the nature of this era, MITI changed its policies from direct control and intervention to one based on to coordinate the activities of the private firms, provide public assistance and incentives in order to motivate private firms' behavior in the desired way.

5.2.4- Administrative Guidance

The experiment of Japan in this period composed of three elements: The development of priority industries that are on the forefront of global markets; second, the practice of consensus-planning and management that serves to coordinate activities of industry; third, the limited use of government incentives.

The underlying theme of these three criteria is that administrative guidance does not have a coercive legal effect. It is implemented without specific legislative jurisdiction. It has to be a legitimate act of an administrative agency (Morishima, 1982, 189). Four observations have been made on the nature of administrative guidance: first, MITI 's other policy tools, such as legal power and subsidies which can be used to enforce its policies, are limited when compared to its extremely wide jurisdiction. Second, administrative guidance, not direct legal enforcement, is suitable at a situation where there is a highly dynamic structure that change frequently to conform changing environment. A lengthy legislative process may not be compatible with time and flexibility. Third, industries under MITI control, are well endowed with financial

resources and are not necessarily eager to obtain the government's financial assistance, they, however, need some initiations and leadership. Finally, administrative guidance was facilitated by the fact that during the period of rapid economic growth, every company had the chance to benefit. It is needless to say, however, that this administrative guidance was not a uniform process, but differed from case to case (Wakiyama, 1989, 215).

Based on the nature of government-business relationships, the Priority Production System (PPS) is often regarded as a successful example of interventionist policy in the heavy and chemical industries. This law was implemented during 1946-48 intended to start reconstruction by concentrating domestic resources into two crucial industries of steel and coal, as they were the only available natural resources. It is note worthy that even at the beginning of the 20th century, steel was the main point of focus for Japan's industrial policies. As successive governments paid serious attention to the revival of steel industry, its central position dominated all economic policies as well as the separation of industrial interest from the agricultural wing of the Ministry of Agriculture and Commerce. The steel industry's central position kept its place even after the Second World War. Moreover, steel and coal were supported because they would contribute employment, export performance, and therefore foreign exchange bottlenecks.

Perhaps a much more important expectation was that revival of these industries would lead to the revival of other industries because of derived demand and positive externalities they would create. In fact, steel production of 740,000 tons in 1947 reached to 100 million tons in the 1970s. The priority production method was a policy of "forced import substitution" till the end of 1960s. Around 1960, heavy industry exports had caught up with the traditionally leading light industry exports; whereas the 1970s era marked a challenging success in heavy industry that far surpassed the light industries. By the end of this "take-off" period, industrial policy entered a new stage.

This period should still be characterized with direct involvement of the state into economic activity. In this period of direct government intervention, until late 1950s, the government implemented some other institutional measures. Among these institutional arrangements, The Temporary Commodities Demand and Supply Adjustment Law of 1946-1952 should be mentioned because it shows very clearly what is meant by the term of direct intervention. According to this law, government could ration, restrict, and even prohibit the production, usage, and shipment of any commodity whose supply was

limited or was found to be inappropriate for the immediate preliminaries of the society in general. We can also argue that this law also gave a legal basis to the Ministry of International Trade and Industry (MITI) policies and empowered bureaucrats in their strict control on the direction of economic activity. It should be added that the dissolution of zaibatsu gave government an extra power for increasing control over the economy.

For instance, as we have discussed before, access to foreign exchange had vital importance for firms because they were in the process of constructing new plants, expanding their scale economies, and transferring new technologies, all of which were controlled and rationed by MITI. Viewed from a government perspective, via MITI and, Ministry of finance (MOF), government not only successfully rationed and controlled these sources in the way of channeling scarce resources into the desired sectors, but also successfully created a forced mechanism for domestic competition.

The Enterprise Rationalization Law of 1952 was enacted and implemented with the aim of providing special depreciation allowances and tariff exemption to key industries. As Kosai notes, "whereas the major goal of priority production had been to resuscitate the coal and steel industries, the main aim of industrial rationalization was to reduce the cost in these industries" (Kosai, 1989, 516). Rationalization of industry took place around industries such as steel, coal, electric power, hydroelectric power, shipbuilding industry and so forth. A priority production system had been carried out by means of direct government controls, and industrial rationalization plans were generally implemented as independent plans carried out by private business enterprises. As a result of these and other precautions, Japan successfully rationalized industry. It imported and then often-improved foreign technology and commercialized it, it liberalized foreign exchange and trade sufficiently to gain entry into the organs of the world economic community (the International Monetary Fund and the Organization for Economic Cooperation and Development), and it exported. Coal, steel, and heavy chemical industries achieved the expected goals in increasing employment, income, and export performance. During the period from 1948 until 1973, the rate of unemployment did not exceed more than1.3 percent.

Other than these institutional factors, Kosai (1989) evaluates macroeconomic factors that conditioned success. Availability of *labor supplies* both in terms of quality and quantity had a significant value. The worker population increased from 3,484, 000 in 1948 to 5,326,000 in 1973. The labor force constituted 65 percent of the population.

Table- 5.1 Rate of unemployment between 1955-1970

Year	ratio	year	ratio
1955	2.6	1963	1.2
1956	2.2	1964	1.1
1957	1.9	1965	1.3
1958	2.2	1966	1.3
1958	2.0	1967	1.2
1960	1.5	1968	1.1
1961	1.4	1969	1.1
1962	1.3	1970	1.2

Source: The Economic Survey of Japan, 1996-97, long term statistics.

High rates of *household savings* which, through the intermediary agency of banks, financed business investment. This period as described by "investment induced investment" was facilitated by the availability of high domestic savings. As economic growth advanced, the propensity to consume continued to decline, and the savings rate increased to twice the pre-war rate. Noguchi showed that 1940 set up had significant effect on the behavior of household savings. "Savings were a mere 6 percent of income in 1930 and rose only to around 10 percent during the first half of that decade. But the rate began rising sharply from 1935 on, topping the 20 percent mark in 1938 and the 30 percent mark in 1941; by the end of the war households were saving close to 40 percent of their incomes" (Noguchi, 1997 and 1998). Meanwhile, the 1940 revision of the tax system led to a sharp rise in income tax rates, which had previously been only 3-4 percent but jumped to nearly 10 percent by 1944. With the increase of both savings and taxes, the share of individual income devoted to consumption fell sharply from around 90 percent in the early 1930 to approximately 60 percent a decade later. The drop in consumption stemmed not from voluntary economizing, of course, but from external forces, such as wartime inflation and controls. What is important, however, is that even under the completely different conditions of the post-war period, the high savings rate persisted.

As can be observed from table-5.2, the rate was around 15 percent during the 1950s and rose to about 20 percent in the 1960s. This can be taken to indicate that the production first principle had become ingrained as a social value. Even in this worst period, Japan strictly refrained from the dominance of foreign capital and heavily relied on domestic savings of the citizens. It is known that this is one of the Japan's persistent

characteristics towards domination of foreign technology since the beginning of modern economic development after Meiji reforms.

Table- 5.2 The household saving rates between 1955 –1970 (percentage)

Year	saving rate	year	saving rate
1955	13.1	1963	15.3
1956	13.7	1964	15.4
1957	11.7	1965	14.9
1958	12.0	1966	14.3
1959	13.4	1967	15.5
1960	14.7	1968	15.6
1961	15.3	1969	16.7
1962	14.8	1970	18.5

Source: The Economic Survey of Japan, 1996-97, long term statistics

Furthermore, the government's successful manipulation of monetary policy to maintain a positive balance-of-payments position had significant value at the time, because balance of payments provided the basic constraint for the economic expansion or contraction of Japan. During any balance of payment crisis, contractionary monetary polices were pursued in order to reduce import demand, and finance development with the existing sources. Table 5.3 shows that excluding the hyper inflation period before 1950 due to war time destruction, shortages, and even production stagnation, pricing mechanisms that kept stability in the wholesale sector while allowing for some inflation in the consumer sector.

Table- 5.3 Price trends (1934-6 average = 1.00)

Period	Annual rate of increase In Whole sale price index	Annual rate of increase in consumer price index
1950	97.3	44.3
1955	6.8	6.2
1960	0.5	1.9
1965	0.4	6.2
1970	2.2	5.5

Kosai, (1989, 500).

At the beginning of the high-growth period, rising individual and corporate income, trend towards equalization in the distribution of incomes, and the growth of demand, especially for consumption goods were strong results of this period. By the

1960s nearly 90 percent of the Japanese "felt" themselves to be enjoying a middle-class standard of living, a consciousness that lead to the rapid diffusion of durable consumer goods, desire for home ownership, motivation for higher university education, and high saving rate, all of which stimulated further growth (Maki, 1998).

Table-5.4 Increase in demand items (annual percentage rate)

	1955-60 (%)	1960-65 (%)	1965-70 (%)	1970-75 (%)
Final private consumption	7.8	9.0	9.7	6.2
Private housing	14.4	17.4	14.0	5.3
Private enterprise	22.2	10.8	22.2	1.1
Final government consumption	2.6	7.1	5.1	5.6
Public capital formation	12.2	16.2	10.8	6.8
Exports	13.0	14.7	15.4	11.8
Imports	16.9	13.2	17.1	6.7
Gross national expenditure	8.5	10.0	12.3	5.0

Source: Kosai, (1989, 513).

An analysis of table-5.4 shows that, despite a serious balance of payment constraint on the economy, substantial savings, abundant and high quality labor, domestic investment race, and consumption demand made rapid growth possible. As the process of mass production also entailed a process of mass-consumer society at the same time, consumption demand also soared. Increased employment together with the increased pace of urbanization and equalization in income distribution provided further motivation for domestic demand. The rates of demand increase for durable consumer goods were remarkable. "Durable consumer goods, such as color televisions, automobiles, and air conditioners, called by such names as the "three household sacred items" or "three C's", were proof of Japan's emergence as a mass consumption society" (Kosai, 1989, 515).

5.3- Rapid Growth and the "Golden Age" of Industrial Policies: 1960-1970

This period is symbolized by Prime Minister Ikeda who disseminated the idea of "double digit" growth rate in the Japanese economy. In fact, during the decade of 1960-70, Japan enjoyed an average growth rate of 11.6 in real terms. This rapid growth era is represented also by the rapid structural transformation of the Japanese economy. This

change was from agriculture to manufacturing, from light industries such as textile to heavy industries such as steel, petrochemicals, and automobiles, a process that is fostered strongly by the availability of export explosion to the foreign markets. As we have discussed above, industrial rationalization and the transformation of high-growth era emphasized the promotion and "picking" of "strategic industries.

The determinants of aggregate supply can be explained with the help of a production function containing capital (K), labor (L), and the technological level (A) would explain the main sources of growth and the role of export and import demand in the performance of Japan's foreign trade.

5.3.1- A Supply Side Analysis of the Sources of Growth

Production Function

$$Ys = F(K, L, A)$$

Or supply function can be shown in terms of Cobb-Douglas Production Function $Y = AK^a L^b$, where $a + b=1$, $b= 1-a$, $0 < a < 1$, a represents the capital share of output, and $(b=1-a)$ represents labor share of output. 'A'denotes disembodied technological component. Decomposition of growth gives the following equation:

$$dY/Y = a dK/K + (1-a)*dL/L + dA/A, \text{ where}$$

$a = rK/Y$, capital share of output, and

$b =(1-a)= wL/Y$, labor share of output.

In terms of supply parameters, the growth takes place as a result of capital accumulation, increases in working hours and employment, technological progress enhancing productivity of capital and labor. An overview of this table-5.6 shows that, Japan had a higher absolute contribution to its growth rate from every factor, and from their main sub-components. In terms of numbers employed, education and international assets, however, Japan lies behind the U.S. rates. One other observation is that longer hours were a positive contributor to growth in Japan, a trend, which was reversed in the post-1960s period. On the other hand, improved resource allocation, that it reallocation

of labor force from low productivity (agriculture) sectors to the higher productivity (manufacturing) sectors, contributed significantly to the growth.

Table- 5.5 Major sources of growth in Japan and US

Average growth rate	Japan		United States	
Period	1953-71		1948-69	
Average growth rate	8.8 %		4.00 %	
Contribution by factor	Absolute	Relative (to 8.8%)	Absolute	Relative (to 4.00)
Labor	**1.85**	**21.0**	**1.30**	**32.35**
Employment	1.14	12.9	1.17	29.3
Hours	0.21	2.4	-0.21	-5.3
Sex, age composition	0.14	1.6	-0.10	-2.5
Education	0.34	3.9	041	10.3
Unallocated	0.02	0.2	0.03	0.8
Capital	**2.10**	**23.8**	**0.79**	**19.8**
Inventories	0.73	8.3	0.12	3.0
Non-residual structure. & equipment	1.07	12.1	0.36	9.0
Dwelling	0.30	3.4	0.28	7.0
International assets	0.00	0.0	0.03	0.8
Technological Progress And residuals	**4.86**	**42.2**	**1.91**	**47.8**
Knowledge	1.97	22.4	1.19	29.8
Improved res.alloc.	0.95	10.8	0.30	7.5
Scale economics	1.94	22.0	0.42	10.5
Total, allowing for Rounding errors		**100.0**		**100.0**

Source: Denison and Chung (1976, 98).

The second observation is that, associated with capital accumulation via the "investment race" in heavy industries, technological progress and residual was the most significant part of growth. More than 50 percent of growth came from this component. These technological subcategories were composed of knowledge improvement in the average state of technology due to technology transfer from the west, better business organization and improvement in management practices. Scale economies in Japan were also a significant contributor to growth in Japan, which confirms the success of MITI

policies for continuous and extra ordinary emphasis on investment along the fast-growth era.

The productivity of the economy rose rapidly owing to extensive technological innovation. In part this was the unavoidable result of having to replace so much of Japan's industrial capacity, which had been destroyed by the wartime bombing. Since the beginning of the Pacific War, Japan had been cut off from most of its Western industrial contacts, and by the 1950s a large body of Japanese engineers and skilled technicians were ready and anxious to close the technological gap that had opened in the intervening years. As Kosai writes:

> "This gap *was* soon closed by the massive introduction of technologies from foreign companies.... Because Japan did not encourage direct foreign investment after World War II, this introduction of foreign technology was achieved through technical cooperation without capital lie-ups...avoiding foreign control of Japanese business. Many foreign firms were willing to sell their technology because the Japanese market was regarded as too small to be worth developing...technical innovations enormously increased the productivity of Japanese industry. The commercialization of technology was the only possible way to achieve technological innovation. The Japanese also tried to improve upon the technology that they imported...thereby enhancing Japan's international competitiveness." (cited in Pyle, 1996, 245.)

Table-5.6 Technological imports, 1949-1975

Period	imported items	price paid (US dollars)
1949-55	1,141	69 million
1956-60	1,773	281 million
1961-65	4,494	684 million
1966-70	7,589	1.536 billion
1971-75	10,789	3.205 billion

Source: Kosai (1989, 521).

As figures in table 5.6 also points out, importation of technology was one of the central components of post-war Japanese industrial policy, and to raise the subject is to turn the discussion to MITI and the Japanese government's role. Before the capital liberalization of the late 1960s and 1970s, no technology entered the country without MITI 's approval. Also no joint venture was ever assigned without MITI's scrutiny and frequent alteration of the terms. Moreover, patent rights were never bought without MITI's pressuring the seller to lower the royalties or to make other changes advantageous to Japanese industry as a whole. No importation of foreign technology

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was ever approved until MITI and its various advisory committees had agreed that, the time was right and that the industry involved was scheduled for "nurturing".

Johnson, however, underlines that the process of technology transfer should beseen a much more complicated matter rather than a simple free rides. He inclines to explain the technology transfer agenda by the industrial policy of successive Liberal Democrat Party governments in the Diet. Technology transfers were not free of cost, but there can be no question that they were crucial to Japanese economic growth and that the prices paid were slight compared with what such technology would cost today, if it could be bought at any price. Japan imported virtually all of the technology for its basic and high-growth industries and it imported the greater portion of this technology from the U.S.A. But it is trivial and misleading to refer to this movement of patent rights, technology, and know-how across the Pacific and from Europe as free ride.

The third, important ingredient of postwar economic growth was Japan's ample supply of highly motivated and well-educated labor. There is, however, no sign that "cheap and abundant labor" was the major contributor during the high growth era. Millions of Japanese returned from overseas to swell the rank of labor, and by the mid-1960s the effects of the postwar baby boom were evident in the rising proportion of young men and women in the labor force. As a consequence, wages did not rise rapidly and did not out-strip productivity. Labor moved to more productive sectors of the economy. The number of agricultural workers declined between 1950 and 1965 by 4.6 million, and over the same period the percentage of the labor force employed in small firms experienced a similar decline. Furthermore, the motivation of the labor force, the willingness to work long and hard with a strong sense of loyalty to one's firm caught the attention of labor economists in many other industrialized countries

5.3.2- A Demand Side Analysis of the Sources of Growth

An overall analysis of Japan's aggregate demand, consists of consumption (C), investment (I), public expenditure (G), and net export (X-M).

Aggregate Demand Function:

$$Yd = C + I + G + (X-M)$$

Among the demand components, investment and exports played key roles in rapid expansion. The ratio private fixed investment to GNP remained very high around 20 percent. This underlines investment was a significant engine of growth until 1970. Note also that the export ratio does not seem to have increased during the 1950s and the 1960s.

First, like the 1950 and the 1960 period, driving force behind economic growth was the high rate of investment. A large share of the GNP was flowed back into new plants and equipment to achieve additional growth. Investment was particularly heavy in export industries and capital goods industries, where demand was strong and the market favorable. A critical factor permitting the unusual amount of investment *was* the high rate of savings achieved by the Japanese. In comparative terms, the personal savings of the Japanese during the 1960s averaged as much as 18 percent of disposable income, while Americans in the same period averaged between 7 and 8 percent. Many reasons are responsible for this high rate of savings including the semiannual lump-sum bonuses paid by Japanese companies, the relative underdevelopment of consumer spending institutions, and inadequate retirement programs. Horioka and Watanabe (1997) showed that among the twelve motivating elements behind the Japanese saving behavior, the retirement motive ranks the first, the housing motive the second, the peace of mind motive third, the illness motive fourth, the education motive fifth, and the marriage motive sixth. Personal and corporate savings together permitted a high rate of investment.

In the course of this remarkable expansion, the structure of the economy underwent a fundamental transformation. Inevitable the relative share of agriculture, forestry, and fishing declined rapidly, while manufacturing and construction experienced a sharp rise. Throughout the prewar period, although the importance of machinery and armaments was growing, cotton and silk textiles had continued to dominate the manufacturing sector. By the 1960s manufacturing output was more diversified and sophisticated, developing aggressively in a variety of areas such as shipbuilding, optics, iron and steel, chemicals, machinery, and consumer durable.

In contrast to prewar times when projectionist sentiments prevailed in many countries, the postwar reduction of trade restrictions caused a rapid expansion of world trade. Between 1953 and 1965 Japanese exports grew an average of 17 percent each year. This impressive performance was the result of much careful and deliberate planning by both government and business to produce goods that had strong world

demand and to achieve price competitiveness through efficient production. Accordingly, Japan abandoned its former concentration on textile exports and turned instead to such new goods as transistor radios, cameras, color televisions, and automobiles. The important point for our discussion is that, as can be observed from the tale-5.4, Japan's growth did not depend so much on exports as it did on the development of domestic markets.

By the later 1960s, Japan's exports were only 9.6 percent of GNP, compared for example with Canada's 19.8 percent from 1953 to 1972, Japan had a consistently lower dependency on export and imports as a percentage of GNP at constant prices than France, Germany, Italy, Britain or OECD Europe as whole. Japan's exports run at about 11.3 percent of GNP, and its imports at 10.2 percent, whereas the OECD European figures were 21.2 percent and 20.9 percent respectively.

There is no question that Japan, as a heavily populated resource deficient country has to export in order to pay for its vital import, but foreign sales were not the main factor driving its economic activity during high speed-growth (Johnson, 1992, 16). Home-demand led Japan's growth for the twenty years after 1955. The demand was there of course, before 1955, but with the coming to power of the Ishibashi and Ikeda opened up domestic demand as it had never been opened before. The propelling force of the economy in this and later periods was private corporate investment nurtured by favorable expectations for the longer term that were created by the governments; it was not export sales (Maki, 1998).

5.3.3-External Factors and Their Impact on the Japanese Economy

The Yoshida strategy was a brilliant adaptation to the conditions in Japan's international environment. Japan made its way in the post-World War-II era by relentlessly pursuing its own narrowly defined self-interest and by frustrating all attempts to engage it in collective security arrangements. This strategy and the underlying foreign policy were a brilliant success because Japan could rely on the United States to guarantee its security and maintain the international order of free trade, leaving Japan free to follow policies of economic nationalism, or neo-mercantilism.

More than any other country, Japan was the beneficiary of the postwar international order. For more than twenty-five years after the end of World War II, Japan operated in extraordinary and uniquely favorable political-economic

circumstances. In contrast to every other major power, it was spared the psychological and material costs of participating in international politics.

Accordingly, the Japanese were able to concentrate their resources and energies on achieving economic growth. The role of America is highly disputed issue for Japan's economic performance. As we have touched upon in the first chapter, the theory of "free rides" argues that Japan is the beneficiary of its post-war alliance with the United States, and that this alliance explains its miraculous fast-growth success. There are three ways in which Japan is said to have enjoyed free rides because of a lack of defense expenditures, ready access to its major exports markets, and relatively cheap transfers of technology. An analysis of Japan's growth accounting would underline the impotence of the external, particularly, the U.S. factors in Japan's performance.

a) America as the Export Market for Japan: Until the late 1960s, Japan benefited from a special relationship with the United States under which the latter sponsored Japanese recovery and development by keeping the U.S. market open to Japan's goods while allowing Japan to limit severely the import of goods into its own economy. At the time of surrender, output had been stumbling along at pre-World War I level. Statistics show the remarkable pace of recovery: from 1946 to 1954 real national income grew at an average of 10.8 percent, an impressive rate, but this achievement merely returned the economy to prewar levels of productivity, national income, and personal consumption.

Thus Japan's foreign exchange reserves, which stood barely at the level of 200 million dollars at the end of 1949, increased to 942 million dollars by the end of 1951, a 4.5 times expansion. Naturally, industrial production enjoyed a sudden boom occasioned by a windfall rise in profit rates between the later half of 1949 and two years later...prices also rose, stimulated especially by the "price is secondary" policy of US Army procurement. The whole sale price index registered a rise of 52 percent and the consumer price index 24 percent within a year after the outbreak of the Korean War." (Tsuru, 1993, 58).

Having regained its former level by 1954-1955, the economy then maintained an astonishing rate of growth for the next fifteen years: 9.1 percent for 1955-1960, 9.8 percent for 1960-1965 and 12.1 percent for 1965-1970. During the high-growth period of 1965-1973 the real growth rate averaged more than 10 percent-nearly three times the growth rate of the U.S. economy during the same period.

b) America as the Pioneer of Liberal Trading Order: The Pax-Americana after 1945 provided a liberal international economic order in which a defeated and outcast nation could take refuge, focus its sights on economic growth, and seek to rise again in a new form. The expanding world trade that the United States *was* promoting through the International Monetary Fund (IMF) and the General Agreement on Tariff and Trade (GATT) permitted a vigorous expansion of Japanese manufactured goods and the ready purchase of abundant and cheap raw materials. Moreover, Japan had easy access to new, inexpensive, and highly efficient Western technology, which it imported in large quantities. As one Japanese scholar commented, "The international environment of the 1960s looked as though heaven had created it for Japan's economic growth." As a matter of fact, Japan's great economic achievements came in the relatively open periods of world commerce- from the Meiji Restoration to world war one and from 1945 to 1970. Considering this observation, MITI officials expressed their concern that the post 1970s era could look like 1920-45 when seen in historical perspective.

The banks and the economic bureaucracy functioned as a general staff behind the battlefield in this second 'total war' called high economic growth. Thus Yoshida and his successors determined to profit from the international order even while flouting its liberal norms. Economic nationalism became a way of enhancing Japan's international prestige, replacing the prewar approach based on military power.

The case of exports is more important. Japan profited enormously from the open trading system throughout the world after the WW II. The favorable effect of the established international institutions, such as the General Agreements on Tariffs and Trade (GATT), the International Monetary Fund (IMF), and until 1971, stable exchange rates, played crucial roles in Japan's foreign trade success. In terms of economic relationships, the U.S. is not only Japan's largest trading partner, but also a major supplier of important raw materials such as food, coal, iron, scrap, and several other services. As the major supplier of technology, the U.S. has contributed much to Japan's rapid economic growth, although the technological gap is gradually narrowing. In the monetary field, Japan heavily depended on the U.S. because Japan's foreign exchange reserves are almost exclusively in US currency, and therefore overseas trade transactions are made mainly conducted in US dollars. Only after the Euro money Japan got a chance of diversifying it foreign exchange reserves.

In sum, Japan's close and cooperative relationships with the Western world constituted the basis of its security both in terms of political, military and economics.

Japan's post-war relationship particularly with America had significant contribution to the revival of Japan after the devastating destruction of the Second World War. This relationship based on the Japan-US Security Treaty is the cornerstone of Japan's foreign relationships.

c) Cold-War and American as Japan's Defense Substitute: Relying on U.S. preoccupation with the Cold War to provide military security and an open market, Japan intensified its bureaucratic controls and strengthened its mercantilist policies. Reversing many Occupation reforms and rebuilding many illiberal political-economic institutions, the country redoubled its efforts in a concentrated economic rather than political struggle. In terms of security, the U.S. nuclear umbrella protected Japan's islands, and the U.S. Seventh Fleet guards Japanese coastal regions, of vital economic importance. The Japan-US cooperation for small allocation for national defense after the mid-1960s less than 1 percent of the GNP (as compared with 6 percent in the prewar days). Substantial resources were thereby freed for investment in more productive industries.

Another fortuitous factor in Japanese growth was the stimulative effect of the Korean War. Before the outbreak of the Korean War, Japan was struggling with a serious stagnation and social turmoil. American foreign aid had sustained the Japanese economy. The United States placed extensive orders with Japanese firms for ammunition, trucks, uniforms, communications equipment, and other products needed for wartime effort. America ordered also other consumer and other goods in order to supply sufficient American aid to the non-communist countries of the Asia. In only one year from 1950 to 1951, the U.S. placed orders with Japanese firms for some 7,079 trucks worth nearly $13 million; this was the key to the revival of the Japanese automotive industry. During the four years that followed to the outbreak of the Korean War in 1950, the U.S. pumped some $ 2.37 billion worth of special procurements into the Japanese economy (Johnson, 1992, 200, 227). In the same way, Tsuru evaluates the impact of the War from the viewpoint of economics as the following way:

> "The rush orders for large quantities of all kinds of support supplies by the U.S. military to the Japanese producers, from galvanized iron sheets and cotton duck to prefabricated buildings and chemicals. These were called "special procurements" paid for in dollars; and the list of goods and services demanded soon was expanded to cover a wide filed of economic activities as the Korean conflict became more intense. In fact, Japan's automobile manufacturing, later to become of world top-rank, acquired the momentum of its early growth from orders for repairing US Army vehicles of all kinds which were flooding in... By

> the time the cease-fire agreement was signed in 1953, the special procurements amounted to a total of 970 million dollars. This category of extraordinary dollar receipts for Japan lingered on until 1955, by which time the aggregate amount was estimated to have reached 3.56 billion dollars. If we take the fiscal 1952 as an example, the dollar receipts due to the special procurements amounted to 62 percent of the total dollar intake of Japan's international payments" (Tsuru, 1993, 60).

In this period, MITI was careful in controlling and directing the foreign exchange, which was gained from trade in the investment activities of the recommended sectors. In addition to these special procurements, the expenditures of the American troops and their dependents constituted 37 percent of all foreign exchange receipts in 1952-53, and they still contributed 11 percent in 1959-60. The war created a boom in textiles, cement and iron and steel industries. Overall, it had the effect of priming the pump and injecting much-needed dollars into the economy, giving it a fast start on sustained rapid growth over the next two decades.

An overall evaluation of the industrial policy until the 1970s is that, any explanation of Japanese industrial development in the context of "government versus market paradigm" is empirically weak. In that context, the "Japan Inc." explanation of postwar economic transformation should be approached with extreme care and an equal stresses on private sector initiative should be made. The private sector dimension of the argument will be presented in the next section. For this section, however, what should be underlined is that business did share information with each other and made their views known to each other, but the final investment decisions were in the hands of the business firms. Economic policy in the years 1945-1973 cannot adequately be explained as tightly managed from the top; rather it was the product of the interaction of bureaucrats, business interests, pressure groups, and the Liberal Democratic Party.

5.4- Structural Transformation: 1970-1980

By the turn of the 1970s, a set of domestic and international developments made it clear that MITI had completed most of its historical missions in the fulfillment of Japan's industrialization. This also should be taken to imply that without making the required structural changes in the organization and mentality of MITI not only it would be criticized as being insufficient and outmoded, but also would seriously damage the economy.

As a result of successive years of high growth during the 1970s, the major agenda of Japan shifted to the side effects of growth such as industrial pollution, corruption and private interest collisions, inflation, resistance to the administrative guidance, and foreign pressures for further competitive measures in terms of trade and finance. Several of the structural changes were undertaken by the government due to foreign pressures and shocks to the Japanese economy. One of them was Nixon Shock during which America declared the suspension of the dollar's convertibility to gold that lead to the end of the fixed-exchange rate regime, and the imposition of an import surcharge. The second major pressure for the urgent transformation agenda of the Japanese economy were the two successive oil crises, first in 1973-74, and then in 1977-78.

5.4.1- Adverse Supply Shock of the Two Successive Oil crisis

During the 1973-74 crisis oil prices quadrupled. One of the initial impacts of these changes on the Japanese economy was in the form of 30 % inflation and 50% rise in the nominal wages, for first time Japan's growth rate was realized in negative terms since the end of the war. Those industries that were heavily dependent on imported raw material or energy and those dependent on export markets fell in serious structural problems.

Table-5. 7 Major macro economic variables during 1971-1982

Year	Growth rate (real)	Inflation rate (WPI)	Money supply (M2, end year %)	Wage increases (nominal, %)	Labor Productivity	Urban Land (1990=100)
1971	4.3	-0.8	24.3	13.4	4.4	15.7
1972	8.5	0.8	24.7	15.6	11.1	13.2
1973	7.9	15.7	16.8	24.2	17.5	25.1
1974	-1.4	31.6	11.5	26.0	-0.5	23.0
1975	2.7	3.0	14.5	11.8	-3.9	-4.3
1976	4.8	5.0	13.5	12.1	12.2	0.8
1977	5.3	1.9	11.1	9.4	5.2	2.1
1978	5.2	-2.6	13.1	6.9	8.7	2.8
1979	5.3	7.3	9.1	6.1	10.7	4.6
1980	4.3	17.8	7.2	7.4	6.3	8.5
1981	3.7	1.4	11.0	6.2	2.3	8.7
1982	3.1	1.8	7.9	3.8	1.1	7.1

Sources: Ito (1997, 71), Statistical Annual, 1979, 1989, Japan Almanac, 1997.

Compared to the first, the second oil crisis had a comparatively minor effect because of the major structural transformation in the private industry and the appropriate macro economic management in this period. Japan's policy outlook till the implementation of capital account liberalization in 1980s was characterized as follows:

1. As can be observed from the table-5.8, the oil crisis lead to a dramatic increase in the commodity prices and in turn was reflected in the major indexes. As the "old" mentality of industrial policy and its institutions preserved by the bureaucratic circles, the opportunity of shifting away from fixed to one of flexible exchange rate regime, after the Nixon Shock, was missed. Accordingly, huge amounts of dollar buying by the Bank of Japan could not be sterilized with the relevant monetary policies. Moreover, the money supply was increased along with active fiscal policies.

2- The employment situation and wage negotiation process showed signs of changes because, at least, employment had changed from excess demand to excess supply.

3- A fiscal balance deficit emerged. In return, the issuance of government bonds, as can be observed from table-5.9, increased dramatically. The fiscal authorities strove to revive prosperity by issuing national bonds and expanding fiscal spending on a large scale, and therefore the Japanese government emerged as a large borrower in the financial market after 1975.

Table-5.8 Trends in government finance in terms of bond and securities (%)

	1965	1970	1975	1978	1980	1985	1988	1990
Government Expenditure/Bond issues	5.3	12.4	25.3	34.7	27.5	21.0	10.1	9.5
Government securities/GD	2.1	5.8	10.6	21.3	29.9	42.6	42.8	39.7

Source: Survey of Japanese Economy, 1997, 1985.

As a result, accumulation of financial assets of households progressed, with the development of the bond market, household preferences for a higher interest rate was strengthened, and it became difficult to maintain the low interest policy of the high growth-period. Therefore, a full-fledged financial liberalization was recognized by the turn of 1980s. Since, however, private borrowing was reduced due to investment

pessimism of the period, interest rates did not rise significantly. The government created a large deficit to stimulate the economy, particularly, after the first oil crisis.

4- As the process of the first oil crisis started turning into one of the major recessions, the overall level of investment also started declining, and fell to its lowest level in 1978. Although the private sector's activity in minimizing energy dependency and making investment in energy saving sectors and therefore lead to a drastic structural change in the economy, in general private sector investment activity was stagnant because of the investment pessimism resulting from the uncertainties surrounding the economy under the external shocks.

Table- 5.9 Major trends in basic economic indicators

Year	Household Savings rates	Exchange Rates	Plant & Equipment Investment (nominal GDP ratio)	Production Index (% change)	Export (1990=100)	Import
1970	18.5	360.00	20.8	10.8	25.2	37.5
1971	16.9	335.27	18.5	2.0	29.7	37.3
1972	17.7	297.06	17.5	10.2	31.9	43.4
1973	19.8	273.88	19.2	13.5	33.0	54.6
1974	23.0	292.70	17.7	-9.7	34.9	49.4
1975	23.1	299.06	16.0	-4.4	40.0	45.7
1976	22.3	292.35	14.9	10.8	48.6	50.4
1977	21.7	256.53	13.9	3.2	52.4	50.8
1978	19.6	201.40	14.1	7.0	49.4	55.8
1979	17.4	229.66	15.1	8.0	53.4	59.7
1980	17.9	217.26	15.7	2.2	62.7	57.1

Source: Economic Survey of Japan, 1996-97.

Among these factors which lead to *investment pessimism,* anxiety over ensuring petroleum supplies took precedence. This prompted a cautionary attitude toward expanding production scales, rising production costs eroded Japan's competitive edge, the future of exports that had increased favorably from the late 1960s was in doubt, and the desire to expand the scale of production was on the wane.

5- Table-5.11 shows that two successive oil crisis reinforced the process of the private sector shift from energy-intensive to one of energy-saving production technologies.

6- Again, looking at the foreign trade figures form table-5.10, combined with the weak yen during this decade, Japanese export to the major developed markets, particularly to the U.S., soared. This finally lead to the emergence of "the Japan problem" for the first time in a serious way and to the chronic trade conflicts with her major trading partners.

As the "Nichibey economy", the mutual dependency of the U.S. and Japanese economy to each other, became evident, the fate of two countries became more complicated and intermingled (Gilpin, 1987, 336).

Table-5.10 Changes in the energy consumption by sectors (unit %)

Period	Industries	Households	Transportation	Total
Between 1969-73	+ 8.5	+11.5	+9.2	+9.2
1973-79	- 0.8	+3.3	+4.2	+0.9
1979-86	-2.1	+1.9	+1.3	-0.4
1986-88	+5.4	+5.3	+4.8	+5.3

Source: MITI.

7- As will be discussed in the next chapter, the major direction and use of trade surpluses were the U.S., and exports of capital to the U.S. expanded on a wide scale, mainly due to huge budget deficit of the U.S..

8- Figures in table-5.12 shows that, the process of internationalization of the Japanese economy made large-scale advances, though leaving behind several conflictual issues. As a matter of fact, the way the Japanese understood the nature of globalization and internationalization of economic activity produced several frictions. That is, Japan even in the post-1980 era continuously pursued "beggar thy neighbor policies". In addition to Japan's "unfair" trade practices, Japan was also criticized because of repressive policies over domestic-demand led economic development. This policy, critics argued, did not contribute to the growth pole of other industrial countries.

Table-5.11 Motives for establishing subsidiary firms in advanced countries-by industries

Industries	trade friction motivation (%)	motive for market share maximization (%)
Office machinery	96.7	negligible
Machine tool	77.1	14.3
Household electric apparatus	53.6	13.6
Electronics	30.0	32.1
Automobiles	66.0	24.0

Source: Tsuru (1993, 195).

Data in table-5.12 indicates that motivation for Japan's subsidiary expansion in other countries were getting much more stronger for escaping trade frictions with other countries. Apart from this "practical" solution, however, it is undeniable that the

Japanese industrial system and its protectors, that is bureaucratic cadre, were under serious strain for change.

5.4.2- Adjustment of Japan to the External Shocks

Under the pressures of domestic and external progresses, Japanese industrial policies underwent a transitionary process toward less direct state involvement in industrial organization. As capital accounts were deregulated in the 1970s, with the floating exchange rate regime, the private sector could accumulate foreign claims or borrow from abroad. This implies that, it was the first time since the Second World War era that MITI and MOF have almost lost their capacity to "guide" the industry with the well-known classical tools of industrial policy such as credit rationing or foreign exchange allocation.

The controversy concerning close bureaucratic control, particularly the one through MITI, intensified with the events around 1970s. One of the events of the decade forcing MITI to re-define its function and role in the process of globalization was the implementation of capital account liberalization. As we have discussed before, behind Japan's policy agenda, the "impact- response" paradigm has taken place along the whole course of Japan's economic modernization. That is, the basic motivation for Japan to change came from external resources. Albeit Japan's dislike of external pressures and therefore a certain degree of resistance came soon after, each time Japan found out her "unique" and sometimes "pragmatic" way of this "enforced" change. This can also be shown in the case of capital liberalization.

After Japan's membership to OECD in 1964, Japan got a chance of utilizing full benefits of this membership, such as easy access to the foreign markets both as an export market or foreign investment market. In response, however, Japan promised to apply capital liberalization measures. Despite this promise, however, a state-sponsored and intellectually motivated era of nationalism emerged because the liberalization measures were interpreted as the "second coming of the black ships" of the Western imperialists. Behind this fear, however, in addition to the fact that Japan's frugality played the key motivation, in reality, the second reason and the real reason was that neither big business nor their protectors, MITI, were ready for a fair degree of international competition. It was the first time that Japan realized that "old" international paradigm fostering Japan's system was in transition.

More precisely, Japan as the successful importer and adopter of foreign technology, was combining technology with its high quality competitive labor power and successfully selling all over the world. The fear was that capital liberalization would reverse the situation. It meant that this competition would take place at every level of enterprise including technology capacity, capital strength, and managerial skills. The Japanese feared that they would be an easy target of destructive competition for foreigners. That is why, under the pressure of foreigners, Japan applied some competitive measures stage by stage, nonetheless, without believing the merits of competition per se.

Upon the emergence of these constraints and complaints, "generalized macro-based fiscal assistance, therefore, was abandoned and instead, micro-based or sector specific industrial adjustment policies were employed" (Okuno-Fujiwara, 1991, 281). According to the Plan for the Liberalization of Foreign Trade and Foreign Exchange, fifty percent liberalization was permitted in 160 categories, and 100 percent in 44 in 1969. In the third stage, in 1970, and in the fourth stage, in 1971, capital account liberalization was applied to the automobile industry, and fifty percent liberalization was permitted in electronic computers and 100 percent in real estate.

Although due to the nature of progresses, the chance of MITI to control industry was limited, it has been also argued that due to MITI's correct perception of these progresses and successful adjustments to the new era, MITI got another chance of increasing its role. This role became visible in the process of mergers and amalgamations, and cartelization of the industrial structure, a process that is frustrated by the psychology of fragility of the competitiveness of the Japanese industry in the new era of more liberal economy.

The first evidence of Japan's reluctance to and anxiety of a competitive economy can be seen in Japan's countermeasures in order to off-set the expected harmful repercussions of liberalization. Capital Liberalization Counter Measure Special Committee of 1967 and Ministry of Finance's Foreign Capital Council functioned together. Early implementation of liberalization took place in industries where competition was unlikely because Japan had already controlled more than fifty percent of the market and the major buyers of the goods and services in those industries were the Japanese and the Japanese government.

Moreover, foreign direct investment was permitted with the conditions of minimum 50 percent Japanese participation and limitation of foreign equity ownership

to 20 percent, and introduction of new foreign technology to Japan were strongly observed criteria by the MITI bureaucrats for permissions. Particularly, introduction of foreign technology was achieved through technical cooperation without capital tie-ups. The commercialization of technology was the only possible way to achieve technological innovation while avoiding foreign control of Japanese business.

The second evidence of fear of competition which was proposed as a solution for external threat was to promote large scale mergers and cartels, especially in steel, computer, automotive, machine tools, petroleum refining, petrochemicals, and synthetic textiles. The merger of Yawata and Fuji steel industries in 1970 so as to form Japan Steel Corporation was assumed as the "merger of the century". This event opened a new era of domestic criticism against the excessive bureaucratic entrenchment in the economy. Since the role of MITI was considerably high on this merger, skepticism for the activities of bureaucrats whether they were in the interest of the society or big business and bureaucrats themselves.

Having considered the impact of liberalizing its trade and capital accounts, the objective of industrial policy shifted to of the strengthening the industrial structure. In order to achieve this objective, besides its policies in favor of mergers such as Nippon Steel merger, MITI further suggested the coordination of fixed capital investment in order to avoid over-capacities, the specialization and coordination of small and medium-size companies, and the establishment of a comprehensive energy policy.

5.4.3- Industrial Policies in Transition

The distinguishing aspect of Japanese industrial policies in the post-oil shock was that according to the program of rationalization and reorganization of the industry, protective measures were applied for sunset industries as well as for sunrise industries. After 1973, for instance, the stagnation of demand for steel and the rise of competition from Asian countries created pressure to reduce excess capacity. But the established recession cartels were used in order to reduce import and prevent access to the Japanese steel market rather than to reduce excess capacity. Despite this, by the end of 1970s, competitive strength of the steel industry in international market increased because Japanese firms were able to introduce new technological improvements.

It should be noted, however, that the Japanese industrial policy for the steel industry worked better during the expansionary phase rather than during the contraction

period of late 1970s. In 1978, the government passed the Law for Special Measures to deal with particular depressed industries such as artificial fibers, aluminum smelting, shipbuilding, etc. This law became the basis of the temporary recession cartels. Members of the recession cartels for the steel industry were financially supported by the Credit Insurance Fund, jointly funded by the government and the industry. Eventually this precaution for the steel industry became successful in reducing excess capacity and preserving its competitive strength in international markets.

The last point should be very surprising due to fact that although profit margins of the Japanese were reduced dramatically because of the adverse supply shock resulting form increased input prices of energy, raw materials and labor cost that eventually lead to the stagnation of demand, MITI recession cartels of the 1970s decreased the rate of penetration of imports from the newly industrializing countries (NICs) and protected profit margins of major firms by preventing excessive price competition.

MITI's industrial policy around the 1970s, however, did not only take the competitive strength of the "targeted" industries into account in terms of growth priorities. The emerging social pressure for the side effects of high-speed growth also provided strong motivation. The Pollution Countermeasures Basic Law of 1967 should be seen as the outcome of domestic pressures on MITI's policies focusing heavily on fast growth, but neglecting its social repercussions. As we have discussed in this chapter, high growth institutions were highly effective in transforming an underdeveloped economy's poor resources into highly prudent outputs, they, however, lacked the necessary institutions, that would introduce the fruits of growth to society in terms of welfare.

The problem here, as will be discussed in the final chapter, was the absence of the required institutions that link growth with development process. The underlying theme in pressures for environmental measures, therefore, advocated that economic privileges should not be given to the high speed growth alone but to the utilization of it for the welfare of the whole society. After the implementation of required legal organizations and laws concerning the environment, in addition to the existing criteria of MITI for the targeted industries such as high income elasticity of demand and high growth rate of productivity, new elements were also added such as overcrowding, environmental and labor content standards, industrial development harmonious with environmental needs, and stricter application of anti-trust policies.

Although the industrial policy of Japan in this transitory period inclined more towards the use of market mechanism and deregulation in the 1970s decade, by the turn of the 1980s, industrial policy still constituted one of the major points of disagreement and disputes between Japan and the major trading partners. One of the serious resistance to this excessive bureaucratic influence, for the first time, came from the Mitsubishi keiretsu group when MITI decided to reduce the number of automotive firms from ten to two including Toyota and Nissan. With its huge financial sources and experience, Mitsubishi established several foreign partnerships, such as with Chrysler, General Motors, Caterpillar, and so on. This first serious appraisal to the "administrative guidance" of MITI was interpreted as the declaration of independence from MITI.

In addition to this domestic resistance to the bureaucratic influence, MITI was also blamed for damaging relations with the U.S. Some retaliatory measures of America and other countries, therefore, put MITI under serious limitation. This foreign pressure was also being shared by domestic industrialists, other than the big ones heavily protected, with the idea that MITI's policies were acting like the "overprotective mama of the industry, that it had become nothing more than damage to the society in terms of pollution, monitored price controls and so on" (Johnson, 1992).

The trade conflicts, particularly with the U.S. should be considered another motivating force for the loss of function in MITI's policies towards industry and the globalization of Japan's industry. In this context, the anti-monopoly law and the MITI fostered depression cartels should be touched upon here. "Even after the 1977 amendment", argues Ito (1997, 204), " the Japanese anti-monopoly law operated with considerable "laxity", compared to its American counterpart". That is why, during the Structural Impediments Initiatives talks of 1989-1990, the U.S. demanded that Japan strengthens its anti-monopoly policy. For Ito, the main problem concerning the anti-monopoly law is related to the interpretation of the legal provisions.

Other than the trade conflict between US and Japan in textile in 1971, in the 1980s, trade conflicts became more acute and more frequent in automobile, computer, semiconductor and so on. In this phase, MITI's main concern was to prevent trade conflicts and to control damage from those conflicts. By the late 1970s, for instance, massive automobile export of Japan to the U.S. following the second oil crisis created trade disputes that lead eventually to adoption of voluntary export restrains (VER) of the Japanese government to the U.S.. Again MITI's role in organizing VER was crucial because MITI established quotas for each automobile firm in order to meet the VER

criteria. The quota allocation was made according to each exporting firm's market performance in the U.S. markets for the last three years and they were given an appropriate export allowance therefore.

Since this system was against large automobile exporters such as Toyota, like the case of Mitsubishi, it also stimulated joint ventures agreements of the Japanese firms to produce in the U.S. and discovered alternative methods to meet the criteria of the U.S. government in import process and consumer demands. That is why, it can be argued that increasing the role of MITI in managing trade conflicts produced further motivation for relocation and internationalization of the automotive industry.

The problem of inflation in this decade also fostered domestic resistance to excessive bureaucratic involvement in the economy. Inflation of the early 1970s was related to the massive expansionary policies of the government for the industrial relocation policy and Japan's public finance system. Moreover, in order to compensate the losses of domestic firms against foreign competition because of liberalization measures and in order to induce domestic demand, the government applied expansionary credit and monetary policies. As a result of this, excessive liquidity syndrome emerged and with their huge idle cash balance of big enterprises, they began in investing land which lead to the emergence of famous speculative boom. This , however, did not only lead to the appreciation of the real estates, but as firms keep land at their disposal as the best alternative hedge against inflation, the share of corporations in the Tokyo Stock Exchange (*Kabushiko*) also started rising. This preference of holding land and goods off the market fueled inflation further due to excess demand.

Against these developments, the cartel structure of Japan's industry was blamed because of flourishing prices under MITI control. MITI's administrative guidance was blamed as the "zaibatsu guidance model". As a result of domestic and external pressures, in the 1973, the first comprehensive revision of MITI's structure since 1952 was implemented. Nevertheless, with the outbreak of the first oil shock, the pressures on MITI were relaxed because the Japanese realized that without bureaucratic involvement Japan unable to overcome this unexpected oil shock severely hitting Japan due to excessive dependence on Middle East oil resources (Akao, 1983). Moreover, the emergency Measures Law for the Stabilization of People's Livehood (1973), the Petroleum Supply and Demand Normalization Law (1973), Temporary Measures Law Against the "Market Cornering" and "Black Marketing" (1973) lead to the pronunciation of some "old" measures such as "direct state control" on the economy.

The second development fostered the restoration of MITI's influence was the strength of the competitive Japanese firms that created serious trade conflicts with the U.S., this lead to the re-involvement of the MITI in industry affairs. Those who support bureaucratic guidance as beneficial, argue that this should be taken as the evidence of that MITI's flexible-minded approach to the industrial policy affairs. That is, depending on the requirement of domestic and external circumstances such as external shocks, foreign pressures, and resistance of the domestic firms to the specific kind of government involvement, MITI took the necessary precautions in order not to lose its control and influence over the industry.

The influence of MITI over the economy was, once again, shaken by the new blames for MITI sponsored cartels of applying some collusive pricing against the Anti-monopoly Law. Combined with such shocking scandals, MITI realized that administrative guidance should be used for national interest and abuse of cartel powers for collusive pricing should be inspected carefully. These last scandals lead MITI to realize merits of being more transparent and accountable to the citizens, that meant further structural reorganization. In fact, the "long-term visions" of the Japanese economy of 1974 outlined in terms of more competitive terminology and perhaps it was the first time that MITI realized the necessity of competing with foreigners even in the domestic markets. Accordingly, foreign trade was liberalized to a large extent. In addition to trade liberalization, by the late 1979, the Foreign Exchange and Foreign Trade Control Law of 1949 and the Foreign Capital Law of 1950 was dismantled or reinterpreted.

5.5- Conclusion

In his detailed investigation on the nature of industrial policy, Okuno-Fujiwara argues that by the turn of the 1980s, due to domestic and external pressures, deep changes in the way of implementing industrial policy took place. For him, "because the Japanese economy had already grown sufficiently and few industries needed assistance for promotion, and partly because foreign criticism against industrial targeting became too fervent to be ignored, the MITI tried to shift its policy emphasis from strategic policies to corrective policies. MITI's position in international trade has gradually chanced to support free trade" (Okuno-Fujiwara,1991, 281).

Komiya and Ito also underline the same point that MITI became one of the pioneers of the free trading regime not only in Japan but in the world as well. The main target of industrial policy, Okuno-Fujiwara argues, in contrast to strategic industrial policies of the high speed growth era, centered on "corrective" policies, such as market failures, particularly failures that arise in the R&D process and failures in moving resources out of declining industries in the process of dynamic sectoral shift. Three main objectives of corrective industrial policies were to provide *adjustment assistance* to troubled industries such as assisting workers to relocate, and to train them for new jobs, providing assistance for depressed areas. Second, to *encourage R & D* in the private sector. Finally, to *address foreign criticisms* of Japan's foreign trade behavior. Among these tools, the establishment of Joint Credit Funds to purchase scrapped facilities with bank-loan guarantees, and allowing a capacity-reduction cartel in designated industries were open to serious criticism for leading corruption and clientalistic relations. As will be discussed in the next chapter, Japanese industrial adjustment assistance policies, in general, were not sufficiently transparent.

The counter argument for corrective industrial policy, on the other hand, says that there is not a very strong change in the use of strategic policies. In her critical comments on Okuno-Fujiwara, Tyson argues that there is a strong continuity at least in the philosophy of industrial policy in two senses: continuity in the basic approach of targeting in leading industries, activities, and even firms for promotion. Second, continuity in the objective of industrial policy to encourage competitiveness in targeted industries because of the special economic benefits they are expected to generate for the entire economy. This argument has sound ground because even in the "post-industrial" era of Japan, MITI has been consciously aiming at promoting commercially optimal technologies. For instance MITI organized the Technology Research Association (TRA) was established with the aim of helping private sector to improve productivity, production technology, and cost-reduction know-how through the orchestrated activities of R&D efforts in the body of TRA.

The projects that were realized under the responsibility of TRA have several distinctive characteristics. First, all of the projects concentrated on the promotion of pre-competitive or generic technology problem, the solution of which will benefit large number of companies. This means that generic R&D support of the Japanese variety still "picks" industrial winners. Second, almost all of these projects have been heavily supported through direct funding of various forms of tax incentives. About one-third of

the total funding for the project was provided directly by MITI. Third, the targeting of a particular technology by the government acts as signaling device to the private sector. Fourth, projects that have been cooperatively funded by business and government. The role of government in organizing this cooperation between selected groups of firms in order to encourage them to share technological information, to adopt common standards, and to create personal network of scientists and engineers for future collaboration. Furthermore, a special cooperative R &D laboratory was established by MITI in cooperation with other participants of the project. Having realized the question-provoking aspect of MITI's policies, Okuno-Fujiwara also underlines that MITI might be accused of applying "disguised industrial policy". As Tyson criticizes clearly,

> "Japanese high technology R &D support is targeted selectively, by activity, by industry, and often by firm. And the goal of such support commercial, not military. The idea driving Japan's program is that government can and should play a role in picking of high-tech winners and promoting them" (Tyson, 1989, 298).

The problem of "outsiders" which would not lead only to the unfair results but also a corruption in the long-term resulting from the collusive nature of rent-seeking activities. In this chapter, it is sufficient to note implications of these kinds of "corrective industrial policies" in international competitiveness. First, Japan's successful infant-industry promotion has been an important factor in its export successes in a variety of technology intensive industries. Second, Japanese companies have been encouraged to invest aggressively to dominate the Japanese market, while foreign competitors have been discouraged to break into the market. Third, it provided strong incentives for the Japanese private sector to cooperate in an exclusive to the outsiders. One can most clearly observe the problem of "insiders and outsiders" in the keiretsu organizations such as reinforced pattern of specialization, distribution, cooperation, and trust that were fostered by the long period of formal protection against outsiders. In the next chapter, an assessment of the Japan's capitalism at micro level, in the case of keiretsu structure will be presented.

VI- NON-MARKET GOVERNANCE STRUCTURES: A Microeconomic Analysis of Corporate Capitalism in Japan

By the turn of the 1980s, Japanese-style management haa achieved great fashion and prestige all over the world. When Ezra Vogel published her book in 1979, academic environment was talking about the role of the keiretsu system for economic growth. It was argued that the Japanese in the post-bubble era, however, a set of interrelated critical questions were directed towards the keiretsu structure: Among these questions I found two of them very important: Has the very same system also led to its 10 year long economic recession during the 1990's? What may the future bring to the keiretsu system? As I will argue in the next chapter, not only Japan's corporate structure should be blamed for the Japan's illness, but also the way of established routines between corporate structure, politicians, and the bureaucratic system should be evaluated at the same time. This perspective is consistent with my hypothesis that the Japanese system should not be reduced to corporate system, but rather it should be considered as a natural outcome of the way of developmentalist ideology as set forth by the modernizing Meiji leaders, and has continued until now without any radical change.

6.1- Explaining Japan's Corporate Structure

Ongoing debate among economists consists of the following three frameworks that purport to explain Japanese enterprise structure. Firstly, a *market approach* that emphasizes economic characteristics of enterprise as response to market opportunities; secondly, a *cultural approach* that sees organization as the expression of patterned values; and, finally, an *authority approach* that explains organization as a historically developed structure of domination which incorporates the elements of market and culture explanations, but does so from the view point of historically developed authority relations that existed among individuals and institutions (Whitley, 1992; Hamilton and Biggart, 1988).

Having used a Schumpeterian view of the corporate principle of economic organization, we are in a position to reject both a pure decentralized and authoritarian view of the corporate structure. For Schumpeter, the generic problem of the capitalism is the lack of coordination, which can be solved through corporate organization. The essential elements of an effective functioning of a corporate structure, however,

centralized tendencies and bureaucratic regimentation should be minimized. In this corporate structure, free individualism and private initiative are seen as essential (Raines and Leathers, 1992, 57). In addition of their emphasis on the organizing and coordinating capacity of corporations, their contribution for conflict resolution and creating harmony between conflictual interests would also be used in understanding the Japanese corporate structure. Schumpeter, by rejecting the concept of a class of struggle between capital and labor, argues that social organism functions through a conjuncture of forces, which contains elements of solidarity as well as antagonism. "In the normal group or society, these conflicting elements are integrated with the co-operative elements harmoniously in the framework of a common culture and faith-which prevents the conflicts from being emphasized" (excerpted in Raines and Leathers, 1992, 53).

As we have discussed under the title of developmentalism, from the very beginning, unlike orthodox neoclassical economics, in Japan, the economic system was interpreted as an *open social system* in the meaning that the economic system can be intervened, first, in order to structure it in the way of maximizing national goals, and second, in the way of harmonizing the so-called conflictual interests between active participants of the political economy. This philosophical thinking for economic reasoning, as combined with the existence of sovereign nation state as the unit of analysis, constituted the basis of the developmental state in Japan. That is, instead of relying on a pure market mechanism, a process of conscious intervention and institutionalization of economics was aimed. The ultimate goal of this non-market governance process was to create an industrial structure that coincides with national strategies of economic development. Corporate structure in Japan should be perceived as an organic part of Japan's industrial structure. But corporate structure should not be interpreted as the main determinant of the Japanese system, but a product of the Japan's developmentalism. In the next section, basic aspects of the Japanese corporate structure and its role in the post war development will be assessed.

In terms of historical analysis, two aspects of corporate culture should be noted at the beginning. Although the cultural school dominated views of Japan's corporate structure attributes sources of corporate culture to the pre-modern practices of Japan, and therefore saw strong historical continuities, in this study, the emergence of Japan's corporate structure is interpreted as the outcome of continuous trials and errors in the face of hardships created by domestic and external factors. In this sense, the period from 1930s until the end of 1945s is a period of indigenisation of several of the foreign

impacts. That is, before 1920s, the corporate structure of Japan was established more on the basis of western practices. By the turn of 1930s, however, according to newly emerging surroundings, the reverse course took place instead of westernizing corporate practices. Japan's modernization until 1945 consists of three periods, preconditions during the Tokugawa period, westernisation during the Meiji era, and indigenization after the Meiji period until 1945.

This sequence of modernization process is also applicable for the post war period, during which, the second round of westernization and a significant pace of convergence took place under the impact of occupation reforms. This continued until the 1960s. After the 1960s, however, an other pace of reverse convergence took place and the corporate practices of Japan was indigenized once again. By the end of the 1970s, however, Japan has already completed establishing its indigenous company structure. Therefore, present day corporate practices of Japan should be understood as the outcome of domestic cultural elements and conscious indigenisation of several external factors in the way of achieving national goals.

What should be underlined here is that the corporate structure of Japan constituted one of the "unique" aspects of Japan's capitalism from a comparative cross-country perspective. If the "pure market" and "authority " approaches are seen as two radically opposite view of explaining Japan, an explanation of corporate structure should combine elements of both market and authority approaches because the influence of authority and the opportunities created by the market came face to face in corporate practices. As Junji underlines, "for the most parts, neither those studying the employment system nor those focusing on the role of state bureaucracy view contemporary economy as a genuinely market oriented capitalism. Instead, one group emphasized the central role of the state or bureaucracy while the other highlights the role of private firms within a cooperative system" Junji (1997, 2).

To make a further elaboration on this point, the corporate capitalism of post war Japan was roughly completed as a result of an alliance between politics, bureaucracy, and business. Distinguishing characteristics of the coming era, as identified increasingly by corporations, was that corporations were structured on the principles of production priorities so as to fulfill the priorities of developmentalism at micro level. Productions first principle was so dominant that all other parameters were put under the service of production. Employment relationships and financial institutions should be analyzed from this perspective. A firm should increase its output and achieve an international

competitiveness and must keep its maximum market share in foreign markets. All factors of productions such as labor and capital should be organized so as to serve to this ultimate goal. Japan's post-war corporate practice, therefore, is being called as "companyism", which implies a high degree of employee loyalty, as expressed by the term *company-men*, and more broadly to describe the overall Japanese system is meant. The goal of post-war Japan was to become a modern democracy, a nation of culture, and peace. Though, these ideals were not completely illusory, in actuality Japan became a country centered on economic growth. Growth was achieved through private enterprise, despite with high degree of state guidance.

Before going on its details, it should be underlined that the term "companyism does not mean the same thing as "Japan Inc.", which has to do with the role of government in economic growth and relationships between government and big business. It should also be recalled that "the Japan Inc.," approach has not been interpreted as the relevant tool of analysis in understanding what really happened in Japan along the course of Japan's development, because this approach emphasizes the close ties between government, bureaucracy, and business, but pays little attention to business organization. The Japan Inc. approach has been associated with the view of Japan as an exception, which has been adopted by some U.S. scholars in recent years. In contrast, the companyism approach looks at firm organization and behavior, allies itself with broader Japanese style management approaches" (Junji, 1997, 5). Many of Japan's scholars share the idea that this sort of companyism emerged in Japan, a period which was characterized by a transition from a market-lead economic development model to a strictly controlled economy operated under bureaucratic control from 1930 until 1945.

Most of the time, foreign observers have called the Japanese conglomerates monopolies. The foreign criticisms, however, do not negate their usefulness and functions in the Japanese economy. Contrary to that, as noted in Pyle, economists of the market persuasion draw attention to a new entrepreneurial vigor in the post war period, the role of corporate strategies, and corporate culture. After all, write Abegglen and Stalk, "companies, not societies, compete for markets; companies, not governments, trade; and in the end it is companies that prosper or stagnate in Japan as well as in the United States or Europe." (Cited in Pyle, 1996, 249).

6.2- An Historical Account of Corporate Structure: Zaibatsu

The historical account of the Japan's industrialization shows that institutionalization of corporate structures embodies a set of cultural and historical constraint. Although this does not suggest that corporate structure is the outcome of so called "unique Japanese cultural values", it does, however, strongly suggest that legitimacy and motivating scheme for certain behavioral patterns contains these elements. The Japanese, for example, needed a system of business collaboration for purely geographical reasons. Nestled on a chain of over a thousand islands, Japan does not enjoy vast expanse of land. Their country has a very high population density. Land in Japan is extremely valuable and raw materials are at a premium. This lack of materials put Japan at an economic disadvantage when the world began to industrialize and globalize during the 20th century. The endless competition for raw materials and the lines of trade that ensued assured that partnerships would be necessary.

The organizational structures of Japanese businesses, however, grew more complex, and the legal basis of many firms was altered to take advantage of new opportunities as time went on. As we have discussed in chapter four, by the second half of the 19th century, stock-issuing corporations (*kabushiki kaisha*) were organized, making it easier to raise capital or to redistribute ownership shares of companies. Several of the largest and politically best connected businesses started or acquired subsidiaries or divisions operating in a variety of industries, and transformed themselves into diversified conglomerates, or zaibatsu.

The system of zaibatsu emerged, wherein large corporate groups were formed and managed under family control. Zaibatsus even began to gain political control in the 1920's and 1930's. These zaibatsus ruled most of Japan's large industrial, financial, and service firms fairly successfully; however, the zaibatsus were broken up by the Antimonopoly laws enacted by the Occupation forces after World War II.

6.3- Emergence of Keiretsu: A Reincarnation of Zaibatsus

One of the most important policies of the Occupation forces was to dissolve the old Zaibatsu. This policy was also supported by the breaking up of other large companies, and the implementation of the anti-monopoly law. Before the war, there were four major Zaibatsu groups and that they established a highly monopolistic structure in

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DOKÜMANTASYON MERKEZİ

industry. They were Mitsubishi, Mitsui, Sumitomo, and Yasuda. Their activities intensified in those industries such as steel, international trade, and banking. These four groups controlled about one third of the paid-in corporate capital by the end of the war (Ito, 1997, 179).

As we have discussed in chapter four, according to initial perceptions of the U.S., the SCAP authorities decided to dissolve zaibatsu type affiliated corporations because they believed that the zaibatsu structure lead to the emergence of a monopolistic capitalism in Japan, and as they were controlled by the military wing, Japan became a serious threat not only for the Asian countries, but also American interests in the region. Again, we have also discussed that, due to a set of domestic and external developments, the occupation forces replaced the initial strict policies one fostering Japan's position in the region.

Triggered by the Korean War that started in 1950, by the independence of Japan through the execution of peace treaty that followed, and by the second revision of the anti-trust law (1953), the corporate stock ownership progressed, and by 1955 Japan roughly formed the structure of corporate capitalism. At that time, *the iron triangle or holy trinity* of politics, bureaucracy, and business was created, and Japan was to move to the era of growth-first principle. Since Japan was familiar to the big business dominance in the pre-war period, the old Zaibatsu structure re-emerged immediately, though under a different name, that is Keiretsu. Although at the beginning, occupation authorities decided that 325 companies were to be dissolved, due to changes in the occupation policies towards Japan, only 18 of them were dissolved.

Yamamura (1997) emphasizes on the importance of changes in corporate ownership that resulted from the Occupation's incompletely implemented Zaibatsu dissolution program. That is, share ownership is far more diffuse than it was before the war. On the other hand, linkages among former Zaibatsu firms have been maintained through informal and formal organizations and cross-holding of shares among these companies. After the reformation of corporate capitalism around the keiretsu structure, a new aggressive breed of Japanese entrepreneurs came to the fore: In place of the top management of major companies who had been purged in the Occupation and who had served the families that owned the Zaibatsu with an emphasis on conservative strategies, reliability, and soundness, came a new set of young professional managers geared to fierce competition in adopting new technology, innovating, and acquiring an expanded market share (Pyle, 1996). They were more inclined to take risks, even in the face of

contrary advice from the bureaucracy. In this strong emphasis on the formation of keiretsu in a similar line to that of Zaibatsu, Japan's feelings of vulnerability as one of the most persistent historical feelings of the Japanese should also be underlined once again. That is, upset and afraid of the foreign occupation, influential Japanese businessmen turned to a system similar to the Zaibatsu system.

Mitsubishi, like other powerful Zaibatsu firms, split itself into many separate companies after the division and gave up the "family control" aspect of business. All of the offshoots of Mitsubishi went on to form what was to become the Mitsubishi keiretsu. Other large Zaibatsu firms did the same thing with their holdings. These transplants became fully independent companies, often competing against each other. In order to protect themselves against competition and to create the best economic situation, the independents aligned themselves with other independents that held the same trade needs and economic interests. The unified companies would be able to reduce costs and ensure economic stability. The partnerships then aligned themselves with banks. The partnerships resulted in less of a chance for loan defaults and a stronger trust from the banks.

However, keiretsu type new partnerships were not the conglomerates that the Zaibatsu firms were, since there was no central strategy or single ownership. Instead of a central strategy, top board executives meet monthly to discuss the economic situation of each individual company. (Hiroyuki, 1997, 85). This meant that with respect to giant corporations that controlled the economy before the war, almost all of the family control was eliminated.

The representative firm in Japan is a large, efficient company operating in a technologically advanced sector and practicing three principles: management-worker joint sovereignty; sharing, and inter-firm competitive cooperation (Ozaki 1991, 172). Keiretsu refers to the horizontally and vertically linked industrial structure of post-war Japan. The horizontally linked groups include a broad range of industries linked via banks and general trading firms. The vertically linked are centered around parent companies, with subsidiaries frequently serving as suppliers, distributors, and retail outlets. Common characteristics among the groups include cross-holding of company shares, intra-group financing, joint investment, mutual appointment of officers, and other joint business activities. The keiretsu system emphasizes mutual cooperation and protects affiliates from mergers and acquisitions. Ties within groups became looser after the oil shocks of the 1970s as a result of decreasing dependence on banks for capital.

6.3.1-Horizontal Keiretsu

Horizontal keiretsus are composed of several dozen members including *a main bank, large financial institutions, largest manufacturing firms, and a large general trading company*. The horizontal keiretsus are well-known with their capacity to provide long-term stability, efficiency, reduced risk, and mutual support. These aspects of horizontal keiretsu were institutionalized mainly through indirect financing system and employment relations.

As can be followed from the table-6.1 and table-6.2, below, horizontal keiretsu structure implies that collection of firms in a horizontal keiretsu pertains to the economy as a whole, widely diversified between manufacturing and service goods.

Table- 6.1 Economic size of six enterprise groups

Financial Year	Number Of member firms Total	Number Of member firms w/o B&I	Average mutual shares (%)	Average intra-group loans (%)	Total Employees (w/B&I)	Total Assets (w/B&I)	Sales (bil.yen) (w/o B&I)
1984							
Mitsui	24	20	17.71	19.68	245,205	46,717	27,824
Mitsubishi	28	24	24.91	23.35	241,533	60,997	28,616
Sumitomo	21	17	24.87	27.15	154,964	54, 472	19,587
Fuyo	29	25	15.72	17.21	336,954	59,388	28,315
Sanwa	42	35	16.56	19.57	400,191	63,106	29,334
Ikkan	47	42	13.67	12.01	496,403	66,336	45,860
1987							
Mitsui	24	20	17.10	21.94	230,447	59,525	27,405
Mitsubishi	29	25	27.80	20.17	240,846	85,524	24,088
Sumitomo	20	16	24.22	24.43	153,202	79,197	20,011
Fuyo	29	25	15.61	18.20	322,798	77,929	26,861
Sanwa	44	41	16.47	18.51	377,622	88,148	31,080
Ikkan	47	42	12.49	11.18	466,250	86,345	48,653

Source: Ito, (1997, 181).

- "W/B &I " (w/o B&I) : With (without) banks and insurance companies.
- Average mutual share = shares owned by other group firms / total shares issued.
- Average intra-group loans = loans received from banks and insurance companies within the group / total loan received.

6.3.2-Vertical Keiretsu

Vertical keiretsu groups are industry-specific affiliations. They are composed of an

affiliation of common suppliers or customers for the same vendor, who is a part of a larger horizontal keiretsu (Constand and Daniele,1998,127). More concretely, vertical keiretsus are multi-level, hierarchical supply chains networking thousands of component or sub-component suppliers serving the keiretsu "parent" at the top of the pyramid (Selig, 1997). Most of the giant vertical keiretsus originated in automobile, electronic, and other industries such as Nissan, Toyota, Hitachi, Matsushita, and Sony. They served to organize huge numbers of subcontractors and suppliers of services. The vertical keiretsu provides efficient, long-term reciprocal benefits for a parent company and its suppliers, including coordination of planning and investment, sharing of technology and information, control of quality and delivery, and flexibility throughout the business cycles (Saito, 1997).

6.4- Elements of Keiretsu Type of Corporate Structure

6.4.1- Cross-Shareholding System

The strength of ties and loyalties is the result of institutionalized long-term contractual relationships among the member firms. The strength of intra-group ties is often measured by the ratio of shares owned by other group firms to total shares *issued (the interlocking shares ratio)* and by the ratio of loans received from banks and insurance companies within the group to total loan received (*the intra-group loan ratio*). As can be followed from the table-6.2, ex-zaibatsu groups have higher ratios of mutual share holding and intra-group loans. Six great enterprise groups-Mitsui, Mitsubishi, Sumitomo, Fuyo, Dai-ichi Kangyo, and Sanwa-were organized horizontally.

Table- 6.2 Weights of the Big Six in the Japanese Economy (%)

	Employees	Assets	Capital	Sales	Profit	
					Gross	Net
1975	5.11	15.76	14.74	14.94	8.29	18.55
1980	4.91	15.34	15.09	15.59	12.08	12.84
1985	4.51	14.24	14.29	16.01	14.22	17.16
1987	4.17	12. 96	15.00	14.35	11.70	11.88

Source, Ito, (1997, 188).

Table-6.2 shows how much weight the big six have in the Japanese economy. They together employ about 5 percent of the total labor force, 16 percent of sales and

profits. About one quarter of the outstanding shares of the 1820 firms listed on the Tokyo Stock and Osaka Stock exchanges were hold by the big six companies. In addition, 38 percent of money lent to these companies come from the financial institutions of the big six.

The major reason behind holding a high ratio of intra-group shareholding is to prevent any possible hostile takeovers, especially after the implementation of capital account liberalization during 1970s. This process has also been reinforced by emerging merger and acquisition activities in the last ten or more years. In fact, holding block share of the large corporations would mean not only the prevention of any foreign hostile takeovers due to low level of capitalization of the Japanese corporations a product of indirect financing system, but also it functions as a "buffer mechanism" in the Tokyo Stock exchange market to prevent excessive fluctuations in stock prices and provide smooth functioning of it. This has crucial implication for the safety of an economic system. Since stock values of firms are measured on the firm's balance sheet at their purchase values rather than their present market values, equity assets of large corporation in interlocking transactions would be undervalued. Since their purchase value does not have to coincide to their market values, it would not possible for outsider to calculate the actual worth of the company. Furthermore, since interlocking-shareholding means that mutual buying of companies in the same corporate group, company not only is isolated from the market by cutting off its ties to the *outsiders*, which is called "taking a company private", but also through buying of each other's stocks, their market values increase at the same time.

The second implication of interlocking shareholding system is to isolate the firm from the shareholder's demand for short-term profit maximization pressures. This in turn implies necessarily the emergence of two important consequences: This isolation increases long-term real entrepreneurial capacity of the Japanese managers due to long-term horizon they achieve due to lack of pressure for short term profit motive. The second dimension is that because of this insulation, they are isolated also from market discipline, in the absence of which accountability to the shareholders, and transparency to the stakeholders are harmed in a serious way. Longer term implication of lack of market discipline is that loss of efficiency in allocating scarce resources would long term performance and competitiveness of the economy. This aspect of the financial keiretsus will be evaluated and criticized in the next chapter.

When one member of the keiretsu falls into financial trouble, the other member plus the affiliated bank pitch in to help. Again, this partnership helps to lower operating risk for each individual company, making each individual stronger simply by being aligned with others. This kind of reciprocal relationships in the business has come to be called a mutual insurance system, and is perhaps the greatest advantage of the keiretsu system. The setting up of a mutual insurance scheme among the group members and particularly between the banks and other group members is an institutional response by the Japanese firm which aims at coping with apparent market failure in contingent claims marked by management risk. Moreover, the problem of capital shortage is reduced through long-term contract with member banks. At the initial stages of development, the problem of capital shortage constitutes one of the barriers in front of undertaking major economic projects. As a matter of fact, in a world of uncertainty, financial transactions are normally costly because accurate information is required, and for the borrower it is often costly to collect. Therefore it is more efficient to establish stable, long-term business relationships with borrowers than to rely on short-term spot transactions. Concerning this cooperative mutual insurance system, indirect financing via the main banks system should be incorporated to the analysis.

6.4.2- Indirect Financing and Entrepreneurship

Those aspects of keiretsu structure such as institutionalized interdependence of banks and firms, the acceptance of low rates of return on equity and investment, and official policy of keeping real interest rates low have significant importance for the comparative efficiency of the Japanese system over the others. Banks in Japan do not only provide loans to the firms but also holds their shares. This is important for the financing of long-term projects. In return, the firms use the bank for major transactions from which the bank earns fees and profits. This system is called the "main bank system". It has been argued that the main bank system has contributed to the efficiency of Japanese financial markets by solving problem of asymmetric information that is inherent in the separation of ownership and management. One of the main functions of the main bank is related to the efficiency considerations in the investment process because, as a lender they have the right to examine the profitability of investment projects and to monitor the performance of management. That is, the place of institutional investors and individual stockholders, to a large extent, has been replaced by the main bank.

The institutional replacement of market mechanism has been important for long-term entrepreneurial performance because it reduced the possibility of hostile takeovers, and insulated the pressure of institutional investors. Since the main bank is represented on the board of directors of the borrower firm, during any kind of business mismanagement of insolvency the main bank will intervene in the process. Especially during any possibility of failure, the role of the bank in rescuing the falling firm by calling in loans and by extra management contributions becomes crucial. As Frenkel notes, "in Japan "internal finance" de facto includes as well borrowing by a firm from its main bank under a long term relationship. The reasoning is that the main bank, like a large shareholder can keep close tabs on what goes on inside the firm, thus largely obviating information and incentive problems...The advantages of lender monitoring are key, and they may explain the real reason why the real interest rate is lower in Japan than anywhere else" (Frenkel, 1991, 257).

A comparative assessment of corporate structure in Japan and the U.S. is provided in table 6.3. The predominance of the financial intermediaries has been one of the persistent aspect of industrial finance in Japan. In the 1950s and 1960s, the banking sector mediated almost all financial flows from the household sector to the corporate sector. This became possible because of corporate over-borrowing. Household sectors keep their savings in the banks as deposits, rather than holding bond or issues, on the one hand, and corporations raise their capital through borrowing from the banks instead of relying on equity finance, on the other. What made this high debt possible and profitable in Japan? Among others following factors were shown among the determining factor of high debt-equity ratio in Japan: 1- Raising financial resources through corporate bonds was considerable expensive because of the regulation that corporate bond must be backed by collateralized assets. 2- The main bank provided long term and cheap credits to the member firms, even during any economic crisis; 3- Until recently all loans had to be collaterized, which reduced the risk from the view point of the lender. This was also a guarantee for the borrower as they know that even in case of economic difficulty, due to collaterization, further debt would be possible; 4- MITI fostered mergers and cartel arrangements reduced the risk of financial difficulty and bankruptcy; 5-the practice of paying workers a substantial fraction of their compensation in the form of twice yearly bonuses that wary with the success of the company acts as sort of profit-sharing mechanism and again reduces the risk of bankruptcy. (Frenkel, 1991, 231).

The possibility of high debt level had two effects; it lowered the cost of capital and enabled companies to leverage investment rates to potentially three times the rate of earnings growth. This capital cost reduction resulted from the special characteristics of firm: "interest payments on debt instruments are usually less than the total returns are expected by shareholders on equity because of the higher risk assumed by them. Another important factor is that, interest payments are deductible from taxes as business expenses while payments to shareholders are not. It obviously affects the ability of the company to grow, but beyond that it affects the quality and productivity as well" (Prestowitz, 1988, 168).

Table-6.3 Total Liabilities and Capital of Firms in Manufacturing Industry
(unit %)

Year	Shareholder's Equity	Stocks	Total Liability	Long-term Debt	Current Debt	Short-term Borrowing	Current Payable
JAPAN							
1969	23.3	12.3	76.8	24.7	49.9	13.5	19.8
1970	22.3	11.1	77.8	24.5	50.7	12.7	21.2
1973	21.1	9.2	79.3	28.2	48.5	12.6	18.1
1976	19.0	7.3	81.1	25.0	53.6	13.5	21.2
1980	22.0	6.7	78.1	22.3	54.9	12.5	22.8
THE U.S.							
1969	56.2	19.2	43.8	19.8	23.9	3.8	9.8
1970	53.8	18.4	45.4	20.5	24.9	4.5	10.1
1973	52.2	17.8	46.8	22.2	24.6	3.6	9.4
1976	53.8	16.0	46.2	22.7	23.5	2.9	8.4
1980	49.6	12.7	50.4	23.6	26.7	3.8	9.8

Source: Aoki (1984, 18).

After all, since the keiretsu structure alone can not be a guarantee of profitability, then, what is the rational of such extensive groupings? A neoclassical answer to that question would say that profitability is the sole incentive. According to Nakatani, however, "contrary to neoclassical expectations, although the formation of groups does increase the monopoly power of respective members, the monopoly power is not necessarily used for rising the rate of profits."(Nakatani, 1984, 227) Nakatani explains this striking aspect of the Japanese firm by the concept of "joint utility". He argues that, "corporate groups maximize joint utility of the corporate constituents. An important thing is the pursuit of a desired mode of distribution of output as well as the stability of corporate performance over time". In other words, "continuity",

"distribution", and "stability" are the essential components of the Japanese corporate structure. Once these goals are guaranteed, it would also mean that objectives of all participants (share or stake holders)from the joint outcome will be maximized. Among the goals of the participants, however, profit constitutes only one element, and it may not necessarily be the most important one. Nakatani's observation on the corporate group behavior is that they earn lower profits, grow at lower rates, have less variability in performance, pay higher wages, have higher debt/ equity ratios, and have lower ratios of dividend payments to capital (Nakatani, 1984). The gist of the point here is that the economic implication of this may be counter-productive in the long-run. This aspect of corporations is left to the next chapter.

Large trading firms (or *Sogo Shosho*) are also considered as one of the unique Japanese non-market governance structures. They are specialized in foreign trade. The top ten of the trading companies control 47 percent of Japan's export, and 65 percent of imports, and 18 percent of domestic wholesale sales. Other than direct involvement in trade, when they serve as intermediaries, for foreign trade, they often provide the credits and short term loans associated with the export-import business. Shogo Shoshos has worldwide networks of branches and stations through which they gather information relevant to the foreign trade. Each of the ex-Zaibatsu groups has general foreign trade companies. Moreover, the distribution keiretsu, allowed manufacturers to control the mass marketing of products. These networks allowed manufacturers to prevent price competition among retailers, to maintain high profit margins in the domestic market, and so to permit 'cutthroat competition' in international markets. In short, the distribution keiretsu became "an effective means to force Japanese consumers to subsidize international competitiveness of large manufacturing firms. It is evident that this structure provides one of the formidable barriers to eliminate or minimize outside trader's penetration to the Japan's domestic market that was instrumental in creating the economic expansion of Japan from 1945 until the early 1990's (Miyagiwa, 1993).

6.4.3- The "Company First" Principle

In the previous section, financial aspects of companyism have been discussed. In the next section, the human resource aspects of it will be introduced. It has been widely believed that the Japanese management system is based on traditions (sometimes "non-traditional traditions" or invented tradition) and policies that confer on Japanese

corporations a kind of social welfare role, including life-time employment, consensus-decision making, seniority based late promotion and reward, strong company loyalty, company unions, and quality control circles. This brief description of the Japanese management system lead to the emergence of so called company person, to be discussed here.

The term company person gives reference to a company employee who, first, gives priority to the firm's interest at the expense of individualistic preliminaries, even without expecting direct compensation for some of the time devoted to work. Second, employee skills are enterprise specific, and can not be transferred to other companies because of the distinctiveness of non-standardized facilities and factory equipment, peculiarities in performing one's professional duties, devoted longer-time periods in the ability to handle relationships with people in conflict resolution, distinctiveness of communications, firm-specific peculiarities of the way constructing a person's career.

The important point here is whether such companyism is relevant when analyzed from the view point of "principle-agent" relations. That is, what is the motivating "incentive scheme" of this system for both sides of the relationship. The recent criticism directed towards companyism is related to the second aspect of a company person because the Japanese enterprise system cultivates a large number of people of talent totally useless for other fields or firms that will not be able to cope with the demand of the era to come. This argument, however, is not validated by empirical observations. The opposite argument, saying that commonality of skills and high labor mobility is prevalent rather than uniqueness of skill to the company. In analyzing the company person, life time employment, seniority based wage system, and company unionism as "the three sacred treasures" of the Japan will be discussed, at least for the culture school approaches.

6.4.4- Life-time employment (*Shunshin Koyo*)

As we have discussed before, one of the main elements of the corporate capitalism is the creation of company person. The creation and maintenance of this, however, closely depends upon the institutionalizing of lifetime employment with seniority wage system (*nenkojoretsu*). The merits and roots of lifetime employment have been well documented. The scarcity of a qualified and experienced labor force during one of the major expansionary periods of the Japanese industry in the immediate aftermath of the

First World War had significant motivation on the innovation and institutionalization of long-term employment systems. In order to keep, at least, the existing labor force at hand against excessive competition in the external labor markets due to serious labor shortage, large business enterprises, particularly Zaibatsus, preferred this system.

A principle-agent explanation of "company man" from the viewpoint of employee can be explained in terms of *worker treatment, which is closely related to allocation of capabilities within the firm.* Keiretsus are famous for "taking care of their own." Proponents of this view argue that long-term job security for each individual worker is the rule rather than the exception. Workers are guaranteed to have a job within the company until retirement, which most likely will come at the age of sixty. During those years of employment, workers are given a high priority in the company. Workers are asked for their input when making decisions. There is greater degree of collaboration amongst workers, usually resulting in a more comfortable and friendly workplace. According to Theory Z developed by William Ouchi; the best management is a family-like environment where a sense of security, and firm identity is created.

Besides this kind of worker treatment, an other significant factor contributing to the institutionalization of worker loyalty is the participatory cooperation in the firm. Among others, two characteristics of Japan's corporate structure had significant impact on the creation of this loyalty: industrial paternalism and an emphasis on group harmony and cooperation. The most significant mechanism through which the latter is manifested is the ring system, whereby proposals are generated and decisions reached through a process of drafting by subordinates, discussion at various levels of an organization, and final approval by senior executives. The ring system enables a representative firm to establish *joint worker-management sovereignty* within the firm. A key feature of this system is that personal responsibility for specific proposals is avoided, even as group harmony is enhanced.

This system, however, is being criticized as not being adequate for the complexities of global competition (Okumura, 1998). Since skills of employees are enterprise specific, this practice limits the adaptability of enterprises to economic slumps. But on the other hand, this system is a guarantee for labor's permanent employment, even during economic turmoil employment adjustments such as relocation, curtailment, seconding, and if the economic situation is worse, voluntary retirements are preferred rather than dismissals. From the view point of employer, at the first observation, it seems that lifetime employment brings a significant amount of

burden to the employer. In order to fully capture the significance of life-time employment, it should be analyzed simultaneously with seniority wage system, through which the cost of a job change was increased and therefore labor mobility has been minimized between different corporations. Despite this external limitation of labor mobility, it is very high within corporations in order to get the benefit of professional capabilities at all possible stages of operations. Another related point is that, because of the long-term employment the external labor market is limited, which implies that the opportunity of jobs in the small and medium sized enterprises is relatively high, but those who change jobs for mid-career jobs will lose both a lifetime income and a social pension to the significant extent. Instead, there is an *internal promotion system* and therefore employees are hired from graduation. This, naturally, implies that the enterprise has to bear the burden of the investment costs of the enterprise-specific skills.

The important point here is that, due to high costs of this investment at the beginning, wages are kept low in order to share the burden of this initial investment. In the middle of their company career, their wages will increase sufficiently according to a seniority wage system. At the higher stages of a worker's career in the corporation, the initial cost of human resource development will be covered, and worker will start contributing to the corporate performance with maximum efficiency. There is, however, no guarantee of return for the employees for their accumulated enterprise specific skills because even if they quit their job; their specific skills might be totally obsolete use at other companies. Therefore, a seniority wage system should be a guarantee for the compensation of accumulated enterprise specific skills.

Furthermore, this "late promotion pattern" has a strong economic rationality as well. "It makes possible the observation of skills and abilities by a larger number of evaluators; through long-term competition; it also provides an incentive to many workers to sustain their ambition" (Ito, 1996, 41). This internal labor market competition and deferred payment, that is seniority-wage system, deters workers from shirking on the job or quitting altogether. This should be to consider an other issue working against external competitive labor market because of this system induces workers to improve their capacities and fully utilize their skills within the enterprise which prevents any competitive hiring to the firm at mid-career position. It was also be argued that since information is open to the insider's close scrutiny via the multiple evaluation schemes, there is no place for moral hazard and adverse selection. Recent evidences, however, strongly rejects this hypothesis, to be discussed in the next chapter.

Another feature of the firm is seen in allocating professional duties. Since wage promotion and professional skills are separated to a large extent, performance evaluation depends on the flexibility of workers in performing multiple responsibilities within the organization. This should be considered one of the significant aspects of creating a company person because a worker will not devote him or herself to a professional and specific job, but rather to the whole of the enterprise. In this way, the fate of workers will be identified with the fate of corporations. This long-term evolution means also that it is not conducted on the basis of short term actual performance, but as a synthesis from a multiplicity of angles, such as potential ability, time span in the service of the company, ethical behaviors and attitudes. Although this multiple evaluation increases the possibility of subjective evaluation and personal discretion, its advantage from the view point of workers is that they know that every aspect of their human assets will be considered in the process of evaluation, therefore they would devote maximum effort and skill to the company affairs and contribute corporation in a more productive and efficient way.

Critics for this multiple evaluation say that worker advancement in Japan is nearly non-existent. All advances in position must come according to seniority rather than aptitude. Thus, many high qualified Japanese are working in jobs below their capabilities, preventing innovation and reducing efficiency.

It would be better to note here that economic rationality of establishing such a corporation environment in a keiretsu environment is striking when we realize the benefits of the system in internalizing positive externalities created by other member firms without paying. Since each member firm has different skills, experience and potential for research and development, this aspect of each firm in the same affiliation provides naturally positive externalities to the other partners. The organization turns out to be a joint profit maximization institution. This joint effort integration provides a frame-work, which shelters conglomerates from unexpected adverse shocks, such as depressed industries, diversifies such risks, and therefore provides a better pay-off matrix to all in the same corporate group.

In sum, life time employment, seniority wage systems, and flexible job assignments should be regarded as a package. With long-term commitments from workers, firms can safely invest in training their workers. Training includes rotating them through different kinds of jobs. Employees do not quit when they become highly trained and valuable. In return for job security, workers accept deferred payments, a

steep age-earning profile, and flexible job assignment. It should also be added that long-term workers commitment or company loyalty have been guaranteed through this late promotion" patterns.

6.4.5- Company Unions: Domestication of the Labor Movement and Creation of the "Company Men"

With the similar logic to the institutionalizing of the life-time employment and the seniority wage system, labor unions have been changed to company unions, particularly, after wide-scale militant labor movements in the post second world war period persisted until 1960s. As these disputes between labor and capital have been perceived as a serious public issue by the state, corporations were also forced and motivated by the state to change their policies from confrontations to one of cooperation and collaboration. It is well documented that the labor union movement was very active within corporations and labor-management disputes persisted until the first half of the 1950s (Gordon, 1991). However, during the 1960s labor-management disputes subsided, with the strike of the Mitsui mines marking the last one. After that, labor unions cooperated with companies to increase productivity, and profit. The unions had the idea that the size of the pie must first be increased in order to win wage hikes. It is sufficient to note here that, by cooperating, in the campaign to raise productivity, the unions would win. In response, the management side engaged in yearly across the board wage hikes through the Spring Offensive (*Shuntō*) method. Management also moved to include employees as part of the company. As Kume points out,

> "...as a result of this reconciliation, labor achieved status as a legitimate member of the company beyond its presence as a production function. In chose to collaborate with management to increase productivity in exchange for its fair share of the profits. Based on this accommodation, labor began participating in production and management decision making through various institutional mechanisms. This dense network of interactions between management and labor contributed to the flexible production system in Japanese manufacturing industries" (Kume, 1998, 2).

This innovation further unified the fate of the company and workers and, therefore, the emergence of a company person. Company unionism shows that employment guarantee is internalized by the corporations, which provides a social security umbrella. This aspect of worker "care", or company person helped the Japanese

economy to overcome the problem of the so-called "trade off" between employees and capitalists, and eliminated labor resistance to the labor saving type of technological progresses.

An assessment of this worker-employer cooperation and collaboration is that, as we have shown in chapter five, more than fifty percent of growth can be explained from increased factor inputs. Table 6.4 shows that among the most influential, in the period 1953-1960, business labor input was the most important contributor to growth (Pilat, 1993, 175).

Table- 6.4 Productivity Growth and Inflation, 1960-1992 (%, annual)

	Japan		United States	
Sector	Prod. Growth	Inflation	Prod. growth	Inflation
Tradable				
Total	6.86	2.96	2.85	3.23
Agriculture	3.55	4.89	3.15	4.21
Manufacturing	6.52	1.87	2.75	3.15
Non-tradable				
Total	3.79	5.20	0.65	5.03
Energy and Transportation	4.36	3.98	2.64	3.78
Construction	2.77	6.89	-1.53	6.94
Distribution and Finance	5.49	3.69	0.80	4.76
Services	1.87	7.70	0.50	5.64
Whole economy	5.29	4.27	1.32	4.50

Source: Ito (1996).

In this way, Japan could survive its productivity performance and be able to survive relative price in stability despite the deep structural influence of the oil crisis on the Japanese economy. That is why, it was argued that Japan could get rid of negative effects of the oil shocks in a relatively shorter time period compared to other major industrialized countries (Tsuru, 1993, 168).

As can be observed from the table- 6.4, table 6.5, and table-6.6, wage increases in Japan were realized above other countries with the exception of France and Germany during the first oil shock. Another observation is that, since productivity of labor in Japan is higher whatever period is chosen, differences between productivity and the wage increase is negative, that is at the expense of labor in Japan. As the periodization is made according to the major economic events, the rate of wage increases in Japan

between 1968-1973, in the golden age of economic development, equalized with the rate of increase of productivity. The situation for the years 1973-79 was reversed due to two successive oil crises during which labor cooperated with business in order to reduce the adverse effect of supply shocks, in terms of production cost and to keep productivity high to the most possible extent.

Table-6.5 Output growth and Contributions to Output growth (%)

	1955 -68	1953 -71	1950 -73	1960 -73	1953 -73	1973 -84	1973 -89
Growth rate of output	10.10	8.77	9.37	10.90	8.63	3.78	3.87
Total factor input	4.03	3.95	4.68	6.40	5.57	3.36	2.94
Labor input	1.31	1.85	1.61	1.64	1.91	0.81	0.94
Capital input	2.72	2.10	3.07	4.78	3.56	2.55	1.99
Output per unit of Input	6.10	4.82	4.69	4.50	3.06	0.42	0.93

Source: Calculations for each different period were undertaken by different authors. See (Pilat,1993, 185).

Table-6.6 Wages, productivity and labor's share, 1952-1970

Country	Average annual wage increase	Annual increase in labor productivity	Labor's share of value added	Rate of increase in labor's share
Great Britain	3.3	2.9	63.9	0.5
United States	1.9	3.4	49.9	-1.5
West Germany	5.7	6.0	40.1	-0.3
Japan	5.4	10.0	33.2	-4.2

Source: (Price, 1997, 252)

Nonetheless, labor unions restrained their wage demands in exchange for government to stop inflation. This informal income policy worked well owing to extensive information exchange among labor, business, and government. As Kume notes, unions, by this way, steadily institutionalized their participation within the political economy from the company level to the national level. In sum, as summarized in Robinson;

> "the established long-term commitment on the part of both labor and management that builds identity, loyalty, and unusual level of trust and confidence typical of the Japanese firm. The common experience, the relatively narrow financial and social distance between the top and bottom, and the sense

of security together make possible a system of consensus and group decision making in which the opinion of all employees are actively sought, acted upon and rewarded. Virtually every one at every level seems to have a sense of personal involvement and identity with work, group, corporate community, and nation...(Furthermore, at the macro level), the Japanese companies are said to enjoy an atmosphere of harmony among government, business, and labor and to be characterized by high ratios of debt to equity in their financing, extensive subcontracting that restrains vertical integration, and resistance to diversification... " (Robinson, R.D.,1982, 49).

Table-6.7 Difference between wage and productivity increases, 1960-89

Period	Increase	Japan	U.S.	Germany	France	U.K.	Italy
1960-68	Wage	5.2%	1.6%	4.3%	4.0%	na	3.9%
	Productivity	9.0	3.2	4.7	6.8	3.4	7.2
	Difference	-3.8	-1.6	-0.4	-2.8	na	-3.3
1968-73	Wage	9.7	1.2	2.6	3.2	2.0	2.8
	Productivity	10.4	3.5	4.5	5.8	3.9	5.6
	Difference	-0.7	-2.3	-1.9	-2.6	-1.9	-2.9
1973-79	Wage	1.7	0.0	2.4	3.7	0.9	5.2
	Productivity	4.5	0.3	3.1	3.7	na	5.4
	Difference	-2.8	-0.3	-0.7	0.0	na	-0.2
1979-89	Wage	1.5	-0.9	1.3	0.9	2.6	0.7
Productivity		4.5	2.3	1.0	2.7	na	4.1
	Difference	-3.0	-3.2	0.3	-1.8	na	-3.4

Source: OECD, Historical Statistics in Kume (1998, 18).

Having considered that these "classical aspects" of the Japanese corporate structure still dominate the Japanese business practices, does this observation imply any repercussions on the future performance of the Japanese companies? On the eve of the last economic crisis in Japan, particularly around the "hallowing out" arguments for Japan's manufacturing industry, it has been argued that the startling performance of the Japanese companies in the 1970s and 1980s were due to output expansions at home and favorable labor settlements rather than to sustainable competitive advantages. It was argued that the success of the 1970s and the 1980s was based on a number of factors such as operational effectiveness, the development of logistics that improved product quality while cutting costs at the same time, and on marginal product differentiation-policies that are transferable to other companies in different cultural context. Some of the well known practices of Japan, for instance, are not only being used in Japan but as

well in America. Among these practices, such as logistic system, just-in-time, that cuts inventory costs, and the total quality system that reduces product defects, improving product quality at the same time. This perspective, however, fails to capture the reality in the sense that, it, implicitly, assumes that corporate practices of Japan is static. In fact, they are changing over the time span to more subtle practices that it becomes harder for competitors to imitate. It is also weak from the view point of competition theory.

Contemporary competition takes place on three planes: operational effectiveness (in terms of cost and quality competition), development of different products (product competition), and market focus. These are the standard competitive strategies which can be easily transferred. "core competitiveness" on the other hand, depends on how enterprise organize themselves, how they use and develop human resources available to them, how they match technology and workers, and their relationships to suppliers and customers and to other firms. Corporate vision provides an ideology to win the enthusiastic support of members of the organization for the introduction and development of software technologies Mourdoukoutas and Papadimitriou (1998, 229).

Japanese corporations are well-known with their success in creating a "community of fate" that is based on participatory management, job security, and joint consultation between labor and management, horizontal communication, team incentives, and a relatively small gap between the highest and the lowest salaries.

On the positive side, these aspects have strong implications which make it unlikely that there will be a radical change in the corporate practices of the Japan in the near future. This is because of the fact that with the present situation, it seems that Japanese corporate structures still retain some vital "indigenous" or "core competencies" in its body, which would ensure its future competitive strength.

One significant result of the life time employment and seniority wage system is the emergence of a dual structure (*niju kozo*) in the external labor market. In fact, there are large discrepancies between large and small companies in terms of wage levels, steepness of wage profiles, and fringe benefits. The role of decentralized enterprise unionism should also be noted in the emergence of Japan's dual economic structure- a highly unionized modern industrial structure coexisting with a poorly unionized small and medium sized corporate sector. For this reason, the Japanese system has also been criticized for being a "corporatizm without labor" (Kume, 1998).

6.5- Conclusion

In the final judgement, as a result of the compromise between labor and management, labor secured rapid wage increases, employment security, reduced working hours, and participation in decision making process. It seems that employment security in Japan has turned out to be one of the persistent features of Japan's employment system even in the worst period of the bubble economic crisis after the 1990s because of the established consensus that "employment should be protected at the expense of a shareholder's interest the because the company is not the private property of shareholders but a social institution" (Kume, 1998, 231). Since companies in Japan have been sheltered from shareholders, this insistence on preserving employment at the expense of shareholder means that business enterprise is sacrificing from its shares for labor. This also means that labor as an organic part of the corporate structure has also been internalized by management, and this in turn, reinforced the community of fate, as a non-transferable aspect of competitive power.

In general, the keiretsu system helped Japan to experience unprecedented economic growth following the Occupation. The heavy regulation and basic structure of the keiretsu helped to keep foreign investors and competition out. Through this resulted a very marginal leakage of total GNP to foreigners for each increase in production. More of the Japanese money stayed in Japan. The employment stability that came with the keiretsu structure helped to set the Japanese unemployment rate at 1% - 2% per year, making it a country ripe for economic growth.

According to the theoretical discussions in the third chapter, observations on the functions of institutions in the process of economic development have the following lesson for keiretsu type of affiliations: Economic goals can not be achieved neither by global central planning nor by the totally profit oriented laissez-faire. A dynamic and innovative system requires a structural combination of variety and rigidity of centralized guidance and decentralized autonomy. In sum, via the smooth functioning of the vertical keiretsus, a continuous procurement of the sources of supply and the direct contact with the markets is achieved. In case of horizontal keiretsu, on the other hand, a strong market power is established and competitive power of the Japanese firms is increased, and therefore any kind of foreign penetration to the same industry is eliminated at the beginning. This does not, however, necessarily imply that keiretsus have prevented foreign penetration because they behave in a collusive manner. It has

been shown that imports and FDI are especially low in markets where keiretsu-affiliated firms have large market share. This evidence, however, has also been used as the counter argument for collusive behaviors in keiretsu structures. Weinstein and Yafeh (1995, 361) showed that "...in fact keiretsus do not collude but compete more fiercely than independent firms, then markets with strong keiretsu presence are likely to be unattractive targets for foreign and domestic entry".

An overall implication of this chapter from the view point of my institutional approach is that dense networks among participants in any economic system play an important role in achieving economic success. In Japan, long-term relations among corporations enabled various firms to improve the quality of manufactured products. Banks as well have had long-term relationships with their customer companies, as both stockholders and lenders. As a result of this lender-customer mutual monitoring system, banks monitor their customer companies, and when the companies are in financial difficulty, the banks tend to organize rescue operations for them. The institutionalized, long-term relationships between large and the small and medium term firms enable Japanese manufacturers to establish flexible mass production. The coexistence and strategic cooperation among them made possible the constant variation of high-quality value added products.

This institutional perspective differs from the market centered approach as it emphasizes the apolitical nature of the success of the economy, as well as from the state-centered approach views Japanese success as a result of state intervention, typically industrial policy. In the present study, however, the role of industrial policy is seen as an important part of the developmental ideology and constitutes only the public sector part of the picture. Therefore, in order to complete the other constituent part of the picture, the role of the private sector in the case of keiretsu structure, as non-market governance structure, has been presented here. In this analysis, therefore, not only the role of the market mechanism, but also the role of non-market transaction cost minimizing, alternative information procurement processes were assessed. Viewed from this perspective, the role of the state, that is industrial policy, becomes much more explicit: what they were, and what they were not in reality. For instance, government interventions, especially in terms of creating and changing the relevant legal infrastructure whenever necessary, created intensive and extensive networks among market actors and provided some companies with favorable opportunities for success.

The emerging side effects and critical aspects of corporate capitalism against the evidences of the post-bubble economy will be focused on in the next chapter.

VII. CONTINUOUS CYCLICAL UP AND DOWN TURNS IN THE 1980s:

The "Destructive Creation" of Corporate Capitalism

As Japan recovered by the turn of the 1980s, Japanese trade as well as current accounts have recorded increasingly large surpluses. The process of recovery and the result of this period, however, invited strong criticism of foreigners concentrating on, first, the chronic trade surplus; second, on government's policy attitudes; and third, the attitudes of the Japanese firms in general. In other words, the way of Japan's recovery from the economic stagnation produced not only a problematic domestic industrial structure, but also an age of "economic conflict" between Japan and major trading partners emerged in the post-1980s era.

Table-7.1 Major economic indexes of Japan, 1980-93

Year	g	IP	U	PE	DR	MS	INF	SP	LP	SCA	LCA	ER	NEA
1980	3.5	4.8	2.0	6.4	7.25	9.2	7.7	7116	12.3	-10.7	2.3	204	12
1981	3.4	1.0	2.2	2.9	5.50	8.9	4.9	7682	11.4	4.8	-9.7	220	11
1982	3.4	0.3	2.4	-3.5	5.50	9.2	2.8	8017	8.3	6.9	-15.0	235	22
1983	2.8	2.9	2.6	-2.0	5.00	7.4	1.9	9894	5.1	2.8	-17.7	232	37
1984	4.3	9.5	2.7	-2.8	5.00	7.8	2.3	11543	3.0	35.0	-49.7	252	74
1985	5.2	3.7	2.6	-1.5	5.00	8.4	2.0	13113	2.2	49.2	-64.5	201	130
1986	2.6	-0.2	2.8	8.2	3.00	8.7	0.6	18701	2.2	85.8	-131.5	160	180
1987	4.3	3.4	2.8	7.4	2.50	10.4	0.1	21564	7.6	87.0	-136.5	122	241
1988	6.2	9.7	2.5	3.9	2.50	11.2	0.7	30159	25.0	79.6	-130.9	126	292
1989	4.8	5.8	2.3	2.6	4.25	9.9	2.3	38916	7.9	57.2	-89.2	143	293
1990	4.8	4.1	2.1	7.6	6.00	11.7	3.1	23849	17.0	35.8	-43.6	135	328
1991	4.3	1.7	2.1	18.6	4.50	3.6	3.3	22984	10.7	72.9	37.1	125	383
1992	1.4	-6.1	2.2	8.7	3.25	0.6	1.6	16925	-5.6	117.6	-28.5	125	514
1993	0.1	-4.5	2.5	3.6	1.75	1.1	1.3	17417	-8.7	131.4	-78.1	112	611

Source: Okabe, (1995, 8).

g: growth rate, IP: industrial production index, U: unemployment, PE: public construction expenditure, DR: official discount rate, MS: Money supply, SP: share prices, LP: land prices, SCA: short term capital account, LCA: long term capital account, ER: Exchange rate, NEA: Net external assets

The major economic indicators of the 1980s are given in table 7.1. In the first half of the decade, the 1985-86 recession might be called "yen appreciation recession", which was brought about by a significant decline in external demand, because of the sharp appreciation of the yen triggered by the Plaza Accord of the Group of Seven countries agreeing to appreciate the exchange of major countries against the U.S. dollar.

The third recession of the post-bubble economy after 1991 is characterized by the "asset deflation recession". During the first two recessions, the main factor came from external shocks such as oil crisis and the appreciation of yen. During the third

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recession, however, main factor behind the recession was domestic factors such as the large scale decline of domestic asset prices which adversely affected the activities of the households, firms, and financial institutions. This recession is known as the first recession generated by the domestic factors.

7.1- The Plaza Accord and an "Asset Deflation Recession"

As I have discussed in the chapter six, a significant characteristic of the 1970s decade is the mode of economic management whereby the government complemented the stagnant private-sector investment and initiated domestic demand with deficit financing expansionary public policies. Considering the major data given in table-7.1, an overall summary of the development in the Japanese economy until the Plaza Accord of 1985 is given below: Contrary to expansionary fiscal policies and deficit finance of the 1970s, after 1981 the government targeted gradual fiscal reconstruction. In that sense, a considerable reduction in bond issuance was observed. The flexible exchange system and free movements of capital flows were recognized by the early 1980s. After the implementation of the capital account liberalization in 1980, because of interest rate differentials between Japan and the U.S., exchange rate trends towards weak yen and the American huge budget deficit, most of the capital outflow from Japan went to the United States. This situation continued until the Plaza Accord of 1985. In other words, the trade or corporate net internal surplus were utilized overseas, and export of capital from Japan to the U.S. expanded on a wide scale.

On the other hand, by the expansion of the economy in the early 1980s, exports –not public spending-offset the saving surplus of the private sector, which lead to the rise strongly in the yen, especially after 1985. Nevertheless, stagnation in the domestic private sector continued until 1986. On September 22, 1985, the representatives of the Group of Five, including Japan, the U.S., Germany, France, and the United Kingdom, gathered together at the Plaza Hotel in New York, and decided to push down the overvalued dollar. The yen appreciated from 240 yen/dollar just before the summit to 150 yen/dollar nine months later. This means that the yen appreciated by 60 per cent in nine months. This was the largest in magnitude in the yen's history, and therefore its results should be scrutinized closely. The post-Plaza Accord Japanese economy, on the other hand, can be summarized as follows

Despite the large scale devaluation of the yen after the Plaza Accord, the Japanese economy shifted from a recession that lasted until the middle of 1986 to a long period of prosperity that run until 1991, the outbreak of the bubble economy. In this expansion, increased domestic demand, reduced import prices, and government's stimulative monetary polices were considered among the decisive factors. Discount rates, for instance, were reduced from 5.0 percent in 1985 to a record low level of 2.5 in 1987. Although this was implemented stage by stage, it was the lowest level since the second world war. This policy, however, was considered one of the strong reasons behind the bubble economy.

After 1985, import prices decreased, which in turn contributed to stability in consumer and wholesales prices, and Japan's competitiveness as well. Private sector investment in plant and equipment and housing increased dramatically, as well as stock and land prices. As can be observed from table-7.2 below, the contribution of domestic demand increased because of soaring private consumption expenditures, whereas foreign demand fell in the same period. Table 7.2 shows the major contributing factors in the period under consideration. Considering the appreciation of yen and strong domestic demand, it is evident that this process worked infavor of producers and against consumers. As the impact of sky-rocketing stock and land prices are also considered, strong deterioration of income distribution in favor of producers, stock and land speculators occurred.

Table- 7.2 Contributions to economic growth by sectors (%)

Year	GDP	CP	PHI	PBI	J	G	DD	X	M	FD
1980	3.3	0.5	-0.7	1.1	0.0	0.0	0.8	1.7	0.6	2.3
1981	3.3	1.3	-0.1	0.4	0.1	0.5	2.0	2.0	-0.8	1.2
1982	3.3	2.8	0.1	0.1	-0.2	0.0	2.7	0.1	0.7	0.8
1983	2.9	1.9	-0.5	0.6	-0.2	0.2	2.1	0.8	0.1	0.9
1984	4.4	1.5	0.0	1.7	0.2	0.1	3.6	2.1	-1.1	0.9
1985	4.6	2.1	0.1	1.9	0.1	-0.3	3.9	0.5	0.4	0.9
1986	2.9	2.2	0.5	0.5	-0.3	0.9	3.9	-0.6	-0.4	-1.0
1987	4.7	2.4	1.3	1.4	0.2	0.5	5.8	0.9	-1.8	-0.9
1988	6.0	3.2	0.3	2.9	0.6	0.1	7.1	1.9	-3.0	-1.1
1989	4.3	2.2	0.1	2.7	0.1	0.2	5.2	2.5	-3.1	-0.7
1990	5.3	2.1	0.3	2.3	-0.2	0.5	5.0	1.3	-1.3	0.1
1991	3.3	1.5	-0.7	0.6	0.3	0.4	2.1	0.8	0.4	1.2

Source: Annual Report on National Accounts, 1993.
GDP: Gross domestic product, CP: Private Consumption Expenditure, PHI: Private Housing Investment, PBI: Private Business Plant and Equipment Investment, J: Inventory Investment, G: General Government Expenditure, DD: Domestic Factors, X: Export, M: Import, FD: others.

7.2- The Uses of Corporate Profits

After the Plaza Accord, two processes have produced persistent effects on the evaluation of the Japanese capitalism. Macro economic policies and deregulation measures of the governments against successive external crisis in the eve of the high-growth era; and the second, which is closely related to the first one, the way of corporate use of internal capital surplus.

By the turn of the 1970s, the internal surplus of firms had reached record levels because of the low level of shares to shareholders. The goal of market share maximization and control of multi-industry resulted in a corporate body in which shareholders, instead of being masters of economic activities, become subservient to the self-perpetuating organization. Institutional motives behind the maximization of internal surplus was the expansion of spheres of control multi-industry-wise and beyond national borders. Table-7.3 shows that the high growth period started with a shortage of capital and high dependency on outside source of gross investment in manufacturing, the internal funds to gross investment steadily rose in the decade of the 1970s and finally exceeded the 100 percent level by 1976. This trend was maintained in the decade of the 1980s.

Table-7.3 Relative growth of internal funds of manufacturing firms
(Unit billion yen)

	Internal Reserve	Gross Investment	FDI
1956-60	77.5	442.2	0.09
1961-65	92.6	940.2	0.13
1966-70	353.8	1,950.7	0.53
1971-75	463.8	2,864.0	2.47
1976-80	811.4	2.903.1	4.13
1981-85	1,193.4	4.774.5	9.43
1986-89	1.907.5	5.976.2	--

Source, Tsuru, 1993, 188, 192.

Of course, the availability of surplus capital alone was not sufficient in providing long term competitive strength for every industry. Ito underlines that "in general, industrial policies succeeded for industries with scale economies, such as steel, and failed for industries without scale economies, such as coal" (Ito, 1997, 199). Tsuru summarizes the stage of corporate capitalism in Japan as follows:

> "What is increasingly happening in Japan is the inter-corporate ownership of corporate equity shares either through mergers and acquisitions or as the continued legacy of the erstwhile zaibatsu ties. This trend is further reinforced

by the shifting emphasis of financial institutions toward investment in bonds and shares and away from long-term loans to manufacturing corporations, this too being a consequence of the expansion of the net internal surplus of giant enterprises. Inevitably there have ensued networks of mutual associated corporate organizations which have become the dominant units of economic activities" (Tsuru, 187).

In the use of their net internal surplus (NIS), it is expected that they would repay their debts to the banks, for they are known with their high debt-equity rations; increase research and development; launch foreign direct investment; spread out its business activities beyond its original field; and, engage in speculative investment in securities and land. Each of these alternatives, however, has far-reaching repercussions on the economy. For instance, in case of paying back their-large scale debt back to the banks, banks will have to face the problem of finding other profitable and sound alternatives for their lovable funds. As we have discussed in the previous chapter, in the emergence of this large-scale debts of firms to commercial and state-owned banks, institutional innovations of both the state along the privileges of industrial policies and the keiretsu type affiliated big corporate structure played the dominant role. Particularly the main bank system, which was argued to have a disciplining and monitoring effect on the effective and productive use of financial resources, was also the primary motivating force behind the excessive drive for market share maximization rather than profit maximization of the firms. The reason is that, "because banks have an incentive to try to maximize their profits from loans, to the extent that they have sway over the firm's production decisions, banks will try to influence to use more capital and expand output levels in order to take on more debt" (Weinstein and Yafeh, 1995, 361).

As a matter of fact, parallel to the expectations, considering the deficit-financing policies of the government after during 1970s, firms shifted their emphasis towards purchasing stocks and bonds. In fact, the relative share of such holdings in the total assets rose from 12.6 percent in 1950 to 32.6 percent in 1971, while the share held by individuals declined from 61.3 percent in 1950 to 37.2 percent in 1971.

Increased R &D expenditure in the same period also shows that internal surplus was used with the aim of restructuring the Japanese economy after the Nixon and two consecutive oil shocks. Table-7.4 shows that a significant part of internal surplus went to the finance of the FDI. In 1986, for instance, 22.320 million dollars were used for FDI. Table-7.5 and 7.6 together makes it clear enough that, trends in the share of Japan's FDI in the world markets has pursued a parallel direction with the share of

Japan's manufacturing export performance, particularly in the post-1980 era. Aside from FDI, in terms of gross-net external assets, Japan surpassed Germany, the United Kingdom, and the United States by 1986 as a result of rapid accumulation in the 1980s. Accordingly, in terms of net investment income received, Japan became a larger net creditor nation as of 1987.

Table-7.4 Share of Japan in world FDI stocks (percentage)

Year	Germany	Japan	United Kingdom	United States
1980	8.39	3.81	15.64	42.82
1981	8.21	4.45	15.56	42.86
1982	8.25	5.20	15.08	40.90
1983	7.93	5.63	14.67	40.32
1984	7.67	6.29	14.40	39.22
1985	8.82	6.47	14.77	36.95
1986	9.64	7.17	14.69	29.89
1987	9.68	7.52	15.59	32.11
1988	8.99	9.56	16.19	29.89
1989	8.83	11.25	14.33	28.45
1990	9.09	12.08	13.84	26.10
1991	9.34	12.49	12.61	25.50
1992	9.22	12.82	11.57	26.06
1993	8.67	12.17	11.66	26.22
1994	8.65	11.68	11.82	25.65

Source: UNCTAD data base, excerpted in Akyüz (1996, 28)

Table-7.5 Share in world markets of manufacturing (percentage)

Year	the U.S.	United Kingdom	Germany	Japan	NIEs
1965-1969	19.05	10.56	17.05	8.54	1.98
1970-1974	15.37	8.34	17.66	10.25	3.39
1975-1979	14.40	7.89	16.92	11.14	4.77
1980-1985	14.62	6.77	16.79	13.36	6.78
1986-1990	11.91	6.20	15.56	13.26	8.61
1991-1993	13.04	5.88	14.18	12.93	9.04

Source: Akyüz (1996, 28).

Until 1980s, the government sector had always been a net creditor while the private sector had always been a net debtor. As can be observed from the table-7.7 below, with the emergence of internal surplus, between 1980 and 1995, the private sector accounted for 71 per cent, while the government sector accounted for 29 per cent of net foreign assets. That is, government became a net borrower, and private sector became the major source of national savings.

Table-7.6 Composition of Japan's net external assets

	1971	1975	1980	1985	1990	1995
Private sector	**-7,088**	**-10,302**	**-16,659**	**104,450**	**218,835**	**505,05**
Long-term	-495	12,931	31,760	172,682	565,542	590,652
Direct investment	514	6,238	16,342	39,231	191,591	276,14
Securities invest.	-3,490	-3,591	-8,305	60,901	229,292	220,678
Loans	-1,620	3,282	13,216	45,659	72,059	17,103
Trade credits	4,853	6,734	9,752	23,472	47,134	41,61
Other	-752	268	755	3,419	25,466	35,109
Short-term	-6,593	-23,233	-48,419	-68,232	-346,707	-85,599
Monetary movem.	-1,471	-13,471	-32,816	-61,26	-254,367	72,530
Other	-5,122	-9,762	-15,603	-6,967	-92,340	-158,128
Government sector	***16,861***	***17,320***	***28,193***	***25,371***	***109,224***	***243,095***
Long-term	2,211	5,823	8,832	6,287	66,521	183,412
Loans	1,809	5,083	15,282	23,209	60,927	134,622
Other	402	740	-6,450	-16,922	5,594	48,790
Short-term	14,650	11,497	19,361	19,084	42,703	59,683
Monetary mov.	14,877	12,103	21,790	23,093	50,894	73,268
Other	-227	-606	-2,429	-4,009	-8,191	-13,594
Total net ext. assets	***9,773***	***7,018***	***11,534***	***129,821***	***320,059***	***748,140***
Long-term	1,716	18,754	40,592	178,969	632,063	774,065
Short-term	8,057	-11,736	-29,058	-49,148	-304,004	-25,926

Source: Masahiro (1998, 15)

Further analysis of table 7.6 shows that among the private net foreign assets, long-term external assets, such as investments and securities investment, rose substantially. The net position of securities investment also rose in the same period. A set of long-term structural factors specific to the 1980s and the 1990s played important roles in the growth of Japan's net foreign assets. These were, first, the changing

comparative advantage of the Japanese manufacturing industry, particularly in high-value added, highly income-elastic manufacturing products (see table-7.6 and 7.7); second, high rates of saving by the Japanese household sector relative to the rates of investment by the corporate sector; third, Japan's liberalization of exchange rates and capital transactions around 1980s; fourth, divergent macroeconomic conditions in Japan and the U.S., such as Japan's marked rise of real wages as the high-growth period progressed, shifting the comparative advantage of labor-intensive products to the less developed Asian countries; fifth, favorable balance of payments; sixth, fluctuations in Japan's asset prices, particularly the yen-dollar exchange rate, stock and share prices, and land prices.

7.3- Towards Asset-Price Deflation of the 1990s

In addition to those targets, in which the internal surplus was used such as in financing of Japan's deficit financing expansionary fiscal polices until 1980, in transforming Japanese industrial structure towards energy saving technological research and development, and in foreign direct investment, a considerable part of the corporate surplus, however, was used for speculative purposes. For instance, according to a survey of Daily Yamiuri Shimbun newspaper in 1989, 78 percent of the landowners declared that they had no project for utilizing land for any concrete economic activity. As can be pursued from the table-7.7 below, land and stock prices increased dramatically after the post-Plaza period.

Table-7.7 Rate of Increase of Land and Stock Prices after 1981 (%)

	1981	'82	'83	'84	'85	'86	'87	'88	'89	'90	'91	'92
Land Prices	8.6	6.8	4.6	5.4	7.3	14.3	25.8	28.0	24.4	30.0	3.0	-15.5
Stock Prices	7.9	4.4	23.4	16.7	13.6	42.6	15.3	39.9	29.0	-38.7	-3.6	-26.4

Source: Hirata (1994, 62)

In general, among the reasons for land price inflation, first, derived demand stemming from increased economic activity in diverse areas. Second, external economies created by increased public sector large-scale projects, particularly in the heyday of recession and stagnation of domestic demand due to successive crises of the

1970s decade, which increased the value of land extremely. As we have discussed in before (chapter 5), bureaucratic entrenchment of the Japanese economy, mainly via the MITI policies, resulted in serious disputes and trade conflicts with major trading partners of Japan.

Table-7.8 Ratio of Export and Imports to the GDP

	1955	1960	1965	1970	1975	1980	1985	1990
Export /GDP-----	11.7	11.1	10.8	12.3	13.7	14.9	16.3	15.2
Import/GDP------	10.8	10.7	9.7	9.7	13.7	15.8	12.5	13.8

Source: Annual Report on National Accounts

Among the foreign criticism and pressures, for instance, one centered on the measures to ensure sufficient domestic demand as the source of growth, rather than relying on excessive export drive had significant repercussions on the economy. As a response, in order to re-structure the economy so as to rely on domestic resources and stimulate domestic demand, government relied, on expansionary policies, particularly, in public works- a major area in which the government could take initiative and pay for the cost. Indeed, the contributions of exports to the real growth of the national economy where 0.5 per cent in 1982, 1.5 per cent in 1983, and 1.2 per cent in 1984.; they became negative in 1986. The collapse of oil prices compensated the negative effect of a strong yen in the same period. It was clear, however, that governments excessive involvement in economic activity via public works would create a favorable environment for corruption and also large-scale public projects would entail the buying of large scale land, which puts extra upward pressure on land price index.

As a result of this, ordinary citizens have lost their hope of owning a residence, particularly, around Tokyo and Osaka, two major industrial locations of Japan. As will be discussed in this chapter, one of the dramatic influences of this asset price inflation took place around income distribution measures. It is argued that the top fifty tax-payers were among land speculators for profit. On the other hand, those speculators who have not yet realized capital gains, secured obtaining large scale loans on the bases of landed property (Tsuru, 1993, 1709).

In addition to the above factors leading to the emergence of bubble economy, there were also serious external parameters which became effective in the process. As we have discussed until now, the Japanese economy has completed the process of

"catch up" with the pioneering industrial countries of the west. Moreover, Japan itself became a candidate of model for not only the developing countries, but also to the ill-going mature industrial economies of the west in terms of its business practices as well as government industrial policies. Furthermore, by the intensified pressures of internationalization, Japan had to take also the necessary reform measures in order to cope with the emerging new issues such as trade frictions, new competitive orientations in the world economy and so forth. Having weakened in the cold war, mainly, between America and the ex-Soviet Republics, the international order has moved towards a uni-polar system headed by the U.S. This, in turn, has implied that the old international ideological frictions would be resolved so that Japan would lose its "most favored nation" or "free-rider" country status. In the emerging historical juncture, Japan's late-comer status, a process in which "catch-up" drives and opportunities dominated the economic policies, a new era was opened to Japan based on "trial and error", a process in which the elements of "learning curve effect" and imitation has already diminished.

Despite these "new experiences" of Japan, the existing system and its creators, that is big business, LDP politicians, and bureaucratic circles were proud of themselves, because of their system, they were praised all over the world for their "miraculous" economic achievements. This "illusion of success", however, has produced barriers for the necessary changes not only because they have believed in the superiority of the system they have established, but also because, as it has already become evident recently, because of the uncertainties associates to the waves of radical reforms (Shimada, 1992). The elements of uncertainty includes both factors of possible failures, rather than achieving desired outcomes and also the fear of losing privileges of the established interest group coalitions. That is, the beneficiaries of the system survived until now without any domestic and external major changes and challenges. In understanding the post-bubble phenomenon, it is suggested to keep this external and domestic situation in mind in order to observe the evolution of Japanese political economy.

The bubble economy in Japan is widely believed to have occurred at the end of 1980s, focusing on stock prices and land prices. However, the concept of the bubble is not clear. After World War II, Japanese land prices rose significantly beyond the rate of return of existing alternative investments and that of consumer prices. At the beginning of this chapter, we have argued that the use of net internal surpluses of the corporations and the macroeconomic policies of the government under the bureaucratic entrenchment

dominated the evolution of the Japan's political economy after 1980s. Until now, we have discussed the use of internal surplus and its repercussions on the economy. The rapid surge in land prices, however, started after 1983. In the next section, the second element of the evolution will be integrated to the analysis.

A macroeconomic explanation of that phenomena is that after the capital account liberalization of the 1980s, the internationalization process intensified and put Tokyo under pressure as one of the major finance centers of the world economy. Going into the 1980s, the concentration of economic activity in Tokyo reached critical levels. As can be followed from table 7.9, from 1987 to 1988, however, rising land prices spread to other major centers of economic activities such as Osaka, Nagoya, and Kyoto, along with the increased demand for land.

Table-7.9 Capital gains from land and stock (relative to the nominal GNP (%)

Year	1983	1984	1985	1986	1987	1098	1989	1990	1991	1992
Land	11.1	12.2	22.6	74.6	117.7	43.8	77.7	54.3	-44.5	-63.6
Stocks	10.7	12.3	10.5	36.1	21.7	47.5	48.5	-71.8	-1.1	-32.9
Total	21.8	24.5	33.1	110.7	139.4	91.3	126.2	-17.5	-45.6	-96.5

Source: Economic Planning Agency (of Japan) (1993, 547).

Rising land prices hindered economic activity of agents who needed land for production or residence. The rise in land prices in the business sector produced the most dramatic result because land price in the business sector exerted influence through increases in collateral strength, and loans for equipment and investment were easily obtained. This constitutes one reason for increases in private equipment investment since 1988. As can be observed from table-7.1, an additional macroeconomic explanation of the bubble phenomena is, related to the government's expansionary monetary policy, mainly via low discount rates after 1986. Advocates of this view argue that an asset price can be derived as a present value of future earning stream. Assuming a constant growth rate in earnings and a constant discount factor, the asset price (P) is given by

$$Pt = Dt/(r-g),$$

where D is the dividend (or rent),
r is the discount rate (interest rate), and
g is the growth rate of the dividend.

In this equation, Dt and g is directly and r is inversely related to the asset price (P), which suggests that as r gets lower, asset price rises. This is in fact what happened to the asset prices including bond and share in Japan between 1986 and 1990 because of the low real interest rates. An assessment of the second half of the decade is summarized in Saito.

> "Reduction of discount rate to 2.5 percent gave rise to a growth in money supply of more than 10 percent. The rise in excess liquidity did not pour into the goods market, where the rise in prices was capped by the rapid increase in cheaper imported goods; instead, it facilitated speculative transactions in the asset market. Reinforced by self-fulfilling expectations of price increases, stock and land prices soared: Average stock price at its peak in December 1989 was 120 percent higher than that at the beginning of the expansionary phase in November 1986. Asset inflation, in turn, stimulated household consumption and corporate plant and equipment investment, and brought about the high growth. A change was also seen in the external balance, where by 1990 the current account balance had declined rapidly to 1.5 percent of GDP from its peak of 4.2 percent in 1986. The widely accepted view at present is that the expansionary phase of the late 1980s was made possible by the asset bubble" (Saito, 1997, 264).

The pattern of the bank lending, however, might be taken at a more much stronger motivation behind this bubble economy. As companies began to get more rich and more competitive on the global scale, it began to be easier for them to raise money on the bond market than to receive loans from banks. So, the role of banks as lenders started to diminish as more and more of the strategic industries began to reach world class levels. The banks saw the ratio of loans/deposit ratio lower as companies were paying back outstanding loans and then depositing more and more money in the banks.

The Bank of Japan still was subsidizing the bank lending by supplying it with money. The banks then turned to the second tier firms and began to throw money in their direction. This greatly increased the risks of loans as many of these companies that were getting money were in real estate and construction, two highly speculative industries. As more and more money began to enter to construction and real estate a boom started to drive the economy into what is now famously known as the bubble. The economy seemed to be expanding so fast as prices for real estate in downtown Tokyo skyrocketed to estimated prices higher than that of the whole state of California. Bank lending to real estate increased sharply in the second half of the 1980s.When the bubble burst, many firms had to absorb financial losses and banks accumulated non-performing (bad) loans.

However, there was something fundamentally wrong with the nature of this kind of investment...it didn't contribute to the increase in productivity. As companies purchased foreign country clubs, corporate buildings and paintings, it was mainly for the sake of doing something with the hundreds of billions of dollars lying around (Masaru, 1998). The reason for this policy is the fear of further revaluation of the yen via the increased interest rates, which would lead capital account reductions. It was shown that this excessive price increase in stock and land reflects the existence of speculative drive because of the expectations for future price increases. Ito (1996) founde out that real estate investment made sense only with low-cost financing and expected capital gains. His findings are validated by the data released by the Economic Planning Agency, as is summarized in figure-7.11. Table shows that there were such capital gains until the end of the 1980s. In fact, the dramatic increase in the market value of financial assets made it easier for private enterprise to raise capital through equity finance in the form of the convertible bonds and warrant bonds in addition to new stocks. Nevertheless, a large proportion of financial assets were purchased by the large institutional investors such as banks and life insurance companies (42 percent) and enterprises (25 per cent) rather than private investors. As a result of this, the negative effect of a strong yen on the profit margins of export-oriented firms was minimized by the involvement of non-price factors in international transactions.

This process also lead to the serious recession in the real sector of the economy; the real growth rate declined, the contribution of domestic factors, contrary to the period between 1985-90, to the economic growth also declined and first time after 1986 foreign demand factors moved upwards in 1991. After the collapse of stock prices in January 1990, the Nikkei 225 index fell to around 15,000, a loss of more than 60 percent from its peak at the end of 1989. In the same manner, land prices peaked around the end of 1990,year after stock prices, and then started on decline that, although not seen as steep as that of stock prices, was more sustained. As of 1996, land prices are also at roughly their level of ten years ago.

As the dollar-based trade balance clearly dropped, the Bank of Japan finally began rising the official discount rate after 1987. When the Bank of Japan raised the official discount rate to 6 percent, the rate of money supply was reduced. In addition, monetary management was changed towards high a interest rate policy.

Table-7.10 Main selective economic indexes of the post-1990 recession

	1990	1991	1992	1993	1994	1995	1996	1997
Real GDP[1]	5.1	3.8	1.0	0.3	0.6	1.5	3.9	0.9
Real private consumption [a]	4.4	2.5	2.1	1.2	1.9	2.1	2.9	1.1
Real public consumption [a]	1.5	2.0	2.0	2.4	2.4	3.3	1.5	-0.1
Real total gross fixed Capital formation[a]	8.5	3.3	-1.5	-2.0	-0.8	1.7	9.5	-3.4
Real total domestic demand[a]	5.2	2.9	0.4	0.1	1.0	2.3	4.8	-0.5
Real export[a]	6.9	5.2	4.9	1.3	4.6	5.4	3.5	10.9
Real import[a]	7.9	-3.1	-0.7	-03	8.9	14.2	11.5	-0.1
Export prices (average unit values)	4.9	-0.3	0.0	-4.7	-1.0	-0.7	7.1	3.3
Import prices (average unit values)	10.6	-9.1	-6.9	-12.5	-7.9	-0.2	16.4	5.6
Export volumes[a]	5.6	2.6	1.5	-2.0	1.7	3.3	0.6	9.5
Import volumes[a]	5.5	3.9	-0.7	3.8	13.7	12.5	3.4	1.6
Output gaps[2]	2.4	3.1	1.4	-0.7	-1.9	-2.4	-05	-1.2
Compensation per employee In the business sector[a]	5.1	4.3	0.9	0.6	2.0	0.8	0.5	1.8
Unit labor costs In the business sector[a]	1.6	2.1	0.9	0.4	1.4	-0.5	-2.9	1.9
Competitive position (1991=100): Relative unit labor cost	94	100	107	129	146	145	121	114
Competitive position (1991=100): Relative export price	93	100	106	119	127	127	121	118
Export performance[a]	-0.1	-4.6	-6.3	-9.1	-10.5	-7.6	-8.9	-1.3
Share in world export markets[g]	8.4	9.0	9.1	9.7	9.4	8.7	7.8	7.6
Share in world import markets[g]	6.1	6.1	5.6	5.9	5.9	6.1	6.0	5.6
Trade balance ($ billion)	69.4	96.1	124.5	139.3	144.1	131.2	83.6	101.8
GDP deflator[a]	2.3	2.7	1.7	0.6	0.2	-0.6	-0.5	0.6
Consumer price index[a]	3.1	3.3	1.7	1.2	0.7	-0.1	0.1	1.7
Employment[a]	2.0	1.9	1.1	0.2	0.0	0.1	0.5	1.1
Unemployment rate[c]	2.1	2.1	2.2	2.5	2.9	3.1	3.4	3.4
Business capital income share	34.1	34.1	33.7	33.4	32.3	31.8	33.2	31.9
Rates of return on capital In the business sector	13.7	12.7	12.4	12.1	12.9	13.4	13.9	14.5
Household saving rates	12.1	13.2	13.1	13.4	13.7	13.8	13.6	14.1
Gross national saving[d]	33.6	34.5	33.8	32.7	31.3	30.9	31.6	-
General government Financial balances[e]	2.9	2.9	1.5	-1.6	-2.3	-3.6	-4.3	-3.1
General government Structural balances[e]	1.8	1.9	0.9	-1.3	-1.6	-2.6	-4.0	-2.6
Short-term interest rates	7.7	7.2	4.3	2.9	2.3	1.2	0.6	0.6
Long-term interest rates	7.0	6.4	5.3	4.3	4.4	3.4	3.1	2.4
Effective exchange rate[f]	91.8	100.0	105.4	126.6	136.3	143.9	125.5	120.1
Net investment income ($ billion)	22.7	26.0	35.6	40.8	40.4	44.2	53.5	55.8
Current account balance ($ billion)	44.7	68.2	112.4	131.9	130.5	110.4	65.8	94.5
Current Account Balance/ GDP	1.5	2.0	3.0	3.1	2.8	2.1	1.4	2.3

a: Percentage changes from previous period, b: Deviations of actual GDP from potential GDP as a percentage of potential GDP, c: commonly used definitions, d: as a percentage of nominal GDP, e: Surplus (+) or deficit (-) as a percentage of nominal GDP, f: Indices 1991=100, average of daily rates, g: percentage, values for total goods

Source: OECD Economic Outlook, December 1998.

The interest rate was raised five times between May 1989 and August 1990. Moreover, a ceiling on bank lending to the real estate sector was introduced as an administrative guidance in March 1990. Third precaution was the imposition of national tax on real estate holdings. These measures finally stopped the increase in asset prices in 1991 and, in doing so, triggered the bursting of the bubble.

The Ministry of Finance disclosed that as of September 1992, the non-performing loans of the leading 21 Japanese banks (11 city banks, 3 long-term banks, 7 trust banks) amounted to roughly $100 billion, in comparison with $64 billion six months earlier. Private forecasts, however, denied these figures and it was declared that real non-performing debts reached to $240 billion at the same date. Still the figure did not reveal the picture because $640 billion of money was lent to affiliated companies of the keiretsu groups and was not counted. In fact, affiliated companies lent their borrowed capital to the property developers (Taniuchi, 1997, 226).

In the mid-1992 and 1993 two successive packages for economic stimulation were declared. In these packages a significant amount of budget was devoted to stimulate the economy and solve bad loan problems. The Bank of Japan applied several cuts in the official discount rates, and it was reduced to historical low level of 1.75 in 1993. A strong yen, associated to still declining land prices, allowed the government to continue stimulus packages without leading to a new speculative bubble, as a result of relaxed monetary policies (OECD, 1993, 38). The idea behind low interest rate, expansionary policy was to stimulate the economy as long as bank loans cannot grow and the national economy remains depressed.

Under the guidance of the MOF, the idea of a Co-operative Credit Purchasing Company (CCPC) was declared and was enacted in 1993. The goal of CCPC was to liquidate the collateral for bad loans by using the public funds. Despite long-lasting disputes on the use of public money in terms of its quantity and quality, the fact was that in the process of liquidation of bad loans, banks were given tax reduction concessions and in order to compensate lose of public revenue, consumption tax was increased to 5 per cent in 1997 from 3 per cent. This means that public funds were spent for the bank rescue operations. One important criticism of the CCPC was that its aim is not to solve the problem of non-performing loans in general, but focuses on those collateralised by real estate (Kasahara, 1994, 15).

7.4- The Credit Crunch and Preventive Measures

Despite the dramatic impacts of the financial crisis on the real part of the economy, the stock and real estate losses weren't seen as too bad for two reasons. One was a general feeling that the crash was a temporary anomaly and that eventually prices would rise again and things would recover. The second was that the Ministry of Finance allowed banks to practice accounting tricks that made the bottom line not seem so drastic.

1- The banks were allowed to use the "book price" of a stock, or the purchase price of the stock to count towards its capital. That is, instead of the real, lower depressed price used in calculating sank credits.
2- Secondly, banks were also allowed to use the purchase price of real estate values instead of the depressed price.
3- Lastly, banks were allowed to use operating profits to cover up some of their bad loans. This practice continued until 1998 when most banks recorded record losses in operating profit after exhausting their reserves (for the latest overview of banking reforms, Nakaso, 1999).

For these, however, the MOF has been blamed, as a performing moral hazard. That is, Japan has a deposit guarantee system without any limitation. The irony to this was that there was no money in the fund as the required reserve and, therefore, deposit money was not properly backed by the government. However, the banks with tons of liquidity to pump into the system, and an assurance that if they lost their money the government would bailout the depositors, threw money at risky investments anyway. This was the moral hazard in the sense that there were no checks on lending, as banks tried to cover their bad debts by lending to even riskier investments. The banks knew that as long as there was no money in the depositors insurance fund, the MOF wouldn't call for a full disclosure of their debts. And it wasn't until the public sentiment changed and realized the magnitude of the crisis that the government would finally call for fiscal help.

In fact, after the collapse of the bubble, the first sign of "recession" appeared in the real estate sector and then quickly spread to financial institutions. Many real estate companies and other companies that speculated with excess funds in the stock and land markets found themselves in serious financial difficulties. In fact, before the collapse,

commercial banks had effectively used rising stock assets to meet the capital adequacy requirement of the Bank of International Settlement (BIS). With their capital base eroded after the burst of the bubble, many banks had to curtail their lending sharply in order to fulfil the requirement. Moreover, construction and real estate companies started to default on interest payments to banks. In the second round of the burst bubble, therefore, banks faced with a large number of bad loans. As a result of a temporary recovery in stock market in 1992 due to government countermeasures for keeping loss of value of assets, banks used their capital gains to write-off some business losses. The Japanese economy had made the transition from a "bubble period of low interest rates, a strong yen, financial deregulation and overall business optimism, to a recessionary period of high interest rates, a weaker yen, selective restrictions on real estate lending and, most of all, general pessimism" (Kasahara, 1994, 7).

Burdened with heavy loads of bad debts, banks have fallen into what we may call a "capital crunch". When their equity capital declines, their solvency comes under doubt. This makes it necessary for them to improve the safety level of their assets. They are thus forced to reduce their lending to corporations, which by nature has higher risks than the holding of assets like government bonds. This is the source of the current credit crunch. Even though corporate demand for loans may be unchanged, banks are cutting back on their supply of lending. In addition to their moves to reduce their assets quantitatively, banks are acting to improve the quality of their assets by being more cautious about credit risk. They have become more selective in their lending policy.

The capital crunch actually began to hit banks in 1991, when the speculative bubbles of the coming years started to collapse, leaving financial institutions stuck with a rapidly growing volume of bad loans (see table 7.11). But the banks managed to keep this from leading to a domestic credit crunch through two methods: the repatriation of overseas assets and the use of operating profits and capital gains on stocks to cover write-offs of non-performing loans. In this way they did their utmost to avoid the shrinking of their own equity capital bases.

What allowed this approach to work was the combination of the authorities' low-interest-rate policy (particularly from 1995 on) and economic expansion (with a year-on-year growth record of 3% every quarter from October-December 1995 through January-March 1997). This combination allowed banks to make profits and thus to work off their bad-debt loads. The approach was growing out of the bad-debt problem, or in other words, of letting banks earn their way out.

Table- 7.11 Bad loans of some selective banks as of 1998

	Percentage to total	percentage change on year
Nippon Credit Bank	23.4	46
Nippon Trust Bank	18.5	11
Yasuda Trust & Banking Co.	11.6	-40
Sumitomo Trust & Banking Co.	9.8	55
Daiwa Bank	8.4	-23
Chuo Trust & Banking Co.	7.5	-5
Mitsubishi Trust &Banking Co.	7.1	72

Source: NIKKEI, Japan Economic Almanac, 1999.

Late in 1997, the banks were finally unable to hide their bad debts with tricky accounting (see, table 7.12). As currency after currency turned bad in South East Asia, investments made by Japanese banks began to turn sour. So heavily did Japan invest into South East Asia that 30% of all loans were made by Japanese banks. As yen began to slide also this presented a new problem altogether. Japanese capital is in yen, but up to 1/3 of all loans were made in dollars again at all other currencies in Asia. As the yen became weaker, this started to erode at the capital/asset ratio. A weak yen means the capital base declines in value compared to the dollars that are lent out. So, in order to keep an adequate capital/asset ratio, the banks either had to lend less, or to spend more money on capital.

It has been estimated by the last quarter of the 1988 that bank loans were around $700 billion dollars. There were other rough estimates forecasting that the total amount of bad debts will eclipse $1 trillion dollars before all the debts are counted for. Taxpayers are rumored to have to pay upwards to $500 billion to bail out the system. That is equal to 12% of the whole GDP of Japan. This is greater than the whole giant construction industry that employs 10% of the work force. As new, smaller businesses apply for new loans the banks are being more skeptical about whom to give loans. They are discounting collateral and demanding higher interest rates for offered loans. This is indicative of how the ability of banks to distinguish good bad risks has diminished greatly.

The government finally came into action, seven years too late, and started to confront the banking mess. The MOF set up new rules for accounting bad debts. They included loans that were in danger of going sour, loans already under bankruptcy, loans that were 3 and 6 months behind on payments and restructured loans. Also, banks were then forced to comply with the international capital/asset ratio of 8 %, a criteria was set

by the Bank of International Settlements in Switzerland. This was all done after there were assurances that public funds would be set aside to actually protect depositors if banks were to fail. Those fears were heightened in November of 1997, as three financial institutions (Hokkaido Takushoku Bank, Yamaichi Securities, and Sanyo Securities.) went bankrupt.

Table-7.12 Capital-adequacy ratios (CAR) (of selected important Japanese banks)

Bank	CAR as of September 1998	required public money injection for 10 percent CAR (billions of yen)
Dai-ichi Kangyo Bank	7.70	701.1
Sakura Bank	6.67	712.8
Bank of Tokyo-Mitsubishi	8.59	767.7
Fuji Bank	6.09	881.4
Sumitomo Bank	8.91	429.4
Daiwa Bank	3.71	356.6
Sanwa Bank	9.08	239.4
Asahi Bank	6.89	316.4
Nippon Credit Bank	5.02	343.0

Source: Commerz Securities (Japan) Co., October, 1998.

Looking at the dramatic situation of the largest banks, as can be observed from the table 7.12, the MOF has taken a strong role in protecting the financial industry, especially banks, from bankruptcy. The bank rescue plan has been called *the convoy system*, according to which whenever there is a company that is about to go under, the MOF redirects it under the protection of a larger bank to help it along with the aim of protecting employment, depositors and borrowers from losing all their assets. On the negative side, however, the convoy system dilutes the good assets and weakens the capital/asset ratios of the good banks. As more and more banks began to weaken, the foreign pressure on the MOF to let the weak banks go under increased. And, in the 1996 and latter part of 1997 the MOF did just this. It let Hanwa Bank, Nissan Life Insurance, Yamaichi and Sanyo Securities and Hokkaido Takushoku Bank fail. However, when Kiushi's bank was rumored to go under, the MOF quickly abandoned the policy of letting the weak go under. The reason of this last policy change was that Long Term Credit Bank (LTCB) was in the same critical position and since it is the world's 22nd largest bank and would have thrown Japan into more deeper recession and perhaps would have carried the world with it.

7.5- The "Big Bang": Reform of the System

Upon the burst of the bubble economy and the long-lasting recession of the economy, Prime Minister Ryutaro Hashimoto put forward a reform proposal in November 1996, which was based on three broad principles of "free", "fair", and "global" standards. Upon launching his new administration, he declared his intention of "breaking the policy logjam by undertaking simultaneous reforms in six key areas: government administration, fiscal structure, economic structure, financial system, social security, and education. The prime minister later labeled the reform process as the "Heisei Reforms" after the name of the current imperial reign, and declared that they marked a "farewell to the post-war systems" of the past half century" (Jouji, 1997). These principles, in general, imply that in the coming decade the system will rely more on market mechanisms by implementing further deregulation measures, transparency, and accountability.

7.5.1- Administrative and Fiscal Reform

The reform of the administrative apparatus, in general, includes five objectives: (1) reform of the central government bureaucracy, (2) deregulation, (3) devolution of powers, (4) disclosure, and (5) reform of public-sector corporations. Accordingly, in terms of *fiscal reform of the public sector*, we can mention five principles: (1)target date for achievement of fiscal consolidation, under which the deficit is not to exceed 3% of GDP by the 2003, (2) till the beginning of 2000s, fiscal reforms should be concentrated and completed, (3) general expenditures for fiscal 1998 are to be set lower than for fiscal 1997, (4) planned spending for all long-term government programs is to be slashed, and no new long-term programs requiring public appropriations are to be drawn up, (5) the "public burden," defined as the total of taxes, social security levies, and the fiscal deficit, is to be kept no higher than 50% of national income even when the age of the population aging reaches its peak.

According to these principles, *Fiscal Structural Reform* plans were started by Prime Minister Hashimoto in 1997. Nonetheless, it suffered a serious set back in 1998 as the priorities of the new Prime Minister Obuchi and his finance minister Miyazawa shifted to the stimulation of the economy rather than fiscal restructuring and public expenditure discipline, because of the deep recessionary effect of the bank failures and

credit crunch on the real part of the economy. As it became clear that Japan's GDP would actually shrink in fiscal 1997, which run through 1998, efforts aimed at balancing the debt-ridden national budget lost momentum. In addition to the 1997 2 trillion tax-cut, another 2 trillion yen tax cut was implemented in April 1998. By the coming of Obuchi government, however, implementation of Fiscal Structural Reform Law was set aside until the economy returned to stable growth. This move led the way for more economic stimulus. The third supplementary budget, worth 5.7 trillion yen, was approved in December 1998. Before the end of the year, the government compiled a budget draft for fiscal 1999. General spending was set at 46.9 trillion yen, up 5.3% from the previous year and the highest growth rate in 20 years. In order to finance the imbalance between lower tax revenue and higher spending, the government plans to issue government bonds worth 31.05 trillion yen in 1999 (Nihon Keizai Shimbun, Japan Almanac, 1999).

The problem here lies in the fact that as financial liberalization progresses, past concessions of the postal saving system will be eliminated. This has a significant implication because in that case depositors will likely shift their assets from maturing postal deposits to private-sector financial instruments partly because the Posts and Telecommunications Ministry has not raised the ceiling on time deposits in postal savings accounts. The nation's ultra low interest rates have weighed on the institution. The interest rate on ordinary postal deposits was lowered in 1998 to 0.15% from 0.20%, reducing the system's advantage over private banks to 0.05 percentage point. The ministry said that it expects its annual deficit to balloon to 1.6 trillion yen in 1999. Responding to rising accusations that the postal savings system represents unfair competition, the government decided to establish a special public corporation to take over the ministry's services, including postal savings and life insurance. The corporation is scheduled to begin operations in April 2003.

As can be observed from table-7.13 and 7.14, the drainage of deposits out of postal savings system would worsen the government's already deteriorated fiscal balances, because a huge drain of postal savings could disrupt the bond market by forcing the Finance Ministry's Trust Fund Bureau to sell some of its government bonds. With 235 trillion yen in deposits, or about 19% of all individual savings in Japan, the postal savings system ranks as the world's biggest bank. But the system, which offers higher returns on saving accounts than private banks do, no longer earns enough money on its investments to cover its costs.

Table-7.13 Outstanding Fiscal and Investment Loan Project (FILP)
(Trillion yen, March, 31, official figures)

Postal savings	139
Postal life insurance	99
National pension fund	134
Other	45
Total	395

Source: JP Morgan, January 29th, 1999.

In the past, the ministry has prevented massive withdrawals of postal savings by raising the ceiling on the accounts and enabling depositors to roll them over. But in light of growing criticism from financial institutions that postal savings steals business from the private sector, the ministry decided to maintain the current ceiling of 10 million yen next fiscal year and thereafter. The ministry said about half of the 106 trillion yen coming might be withdrawn because depositors will be attracted by private-sector financial instruments, such as investment trusts.

Table-7.14 Consolidated balance sheet of general government
(trillion yen, March, 31, 1997, official figures)

	Central	Agencies	Local	Social Security	Total
Gross assets	84.4	63.9	43.3	228.5	408.1
(as % of GDP)	16.8	12.7	8.6	45.4	81.0
Gross liabilities	310.7	57.6	124.9	1.5	482.7
(as % of GDP)	61.7	11.4	24.8	0.3	95.8
Net assets	-226.4	6.3	-81.6	227.1	-74.6
(as % of GDP)	-45.0	1.3	-16.2	45.1	-14.8

Source: JP Morgan, January, 29, 1999.

As of today, the combined fiscal deficit of Japan's local and central governments is expected to amount to 10% of the nation's gross domestic product, the worst figure among the Group of Seven nations, according to the Organization for Economic Cupertino and Development. Accumulated government debt is expected to reach 108.5% of GDP, next only to Italy's 117.5%. Japan's Finance Ministry estimates that total accumulated government debt in fiscal 1999 will amount to 6.9 times more than the tax revenue expected in the same year. The government debt will be ´2.59 million per Japanese citizen (JPMorgan, 1999).

In the area of *economic structural reforms*, the aim is to revive an economy suffering from the hollowing out of the industrial structure and the rapid aging of the

population by encouraging the creation of new industries and correcting the existing structure of high costs. The reform program contains about 500 items for consideration, including (1) a major reduction of transportation costs through deregulation by 2001, (2) reduction of electric power costs to international levels, (3) achievement of more efficient use of capital by lifting the ban on holding companies and simplifying the legal requirements for mergers, and (4) promotion of labor force mobility with the adoption of systems to evaluate employees not by hours worked but by performance. The overall goal is to clarify businesses' responsibility for their own affairs and to promote free competition.

7.5.2- Reform of the Financial System

In terms of *reforming the financial system*, the big bang included (1) elimination of the barriers separating the banking, securities, and insurance industries, (2) lifting of the postwar ban on financial and other holding companies, (3) deregulation of insurance premiums, (4) liberalization of foreign exchange, (5) reform of the corporate accounting system, with a shift from valuation of assets at acquisition cost to valuation at current market prices, (6) review of the financial regulatory system and, in particular, strengthening of the supervision of financial institutions, and (7) revision of the Bank of Japan Law to give the central bank greater autonomy.

In 1998 an *Economic Strategy Council* was established. This is the body appointed by Prime Minister Obuchi to advise him on a fundamental strategy to revive Japan's economy. Members come from business and academia. The council, established on Aug. 24, 1998, proposed emergency measures in October. In February, the council proposed a long-term economic strategy. In the following section, basic aspects of these latest legal precautions will be discussed.

The Japanese version of a big-bang, discussed above, created new business chances, Japanese firms were not be able to take advantage this new era, mainly, because they used most of their profits to write off bad loans and expand loan-loss reserves, and could not expand their work forces sufficiently. A decline in the Nikkei Stock Average from 17,000 in March to below 13,000 in October expanded their unrealized losses. With the temporary nationalization of the Long-Term Credit Bank (LTCB) and Nippon Credit Bank (NCB), the negative image of the financial markets in Japan deteriorated further. As combined with the lack of transparency, one percent

Japan premium (LIBOR +1) was imposed on the credit demand for the Japanese firms in foreign markets, which enhanced the existing strain. Market worries over the weak asset quality of Japanese banks put upward pressure on the banks' fund-raising costs throughout 1998. The pressure prompted them to aggressively call in loans to minimize further losses from bad-debt problems. The Bank of Japan continues easy monetary policy throughout the period in order to re-capitalize banks. Market worries, however, culminated by the bankruptcies of the LTCB and NCB.

7.5.3- The Bridge Bank System and the Use of Public Funds

In this course, the Japanese government has been long criticized for not acting decisively against the nation's huge bad-loan problem. Government finally managed to boost market confidence in the financial system after enacting a package of bills in October 1998 to prevent any bankruptcy of a major bank from igniting a systemic meltdown. The bills have two main functions. One function is to allow the government to take control of a failed or failing bank in one of three ways: temporary nationalization through share purchases; liquidation through a government appointee; or transfer of operations to a publicly funded bridge bank.

Table- 7.15 Financial reform schedule implemented as of 1998

March 12	Injection of public money to 21 Japanese banks.
April 23	A Total Plan was launched for the liquidation of loans and real estates.
June 22	Financial supervisory agency starts operating.
June 25	LTCB share price falls to 50 yen.
June 26	LTCB and Sumitomo Trust and Banking intend a merger plan.
July 2	Government Declared a Bridge Bank plan.
August 21	LTCB announces restructuring plan to receive public funds.
September 27	Japan Leasing Corp. goes bankrupt.
October 6	Nikkei stock average falls below 13,000 for the first time for the last 13 years.
October 8	Sumitomo Trust changes plan for merger with LTCB.
October 18	The Law of Bank Re-capitalization Law passed in the diet.
October 23	LTCB was nationalized.
December17	Nippon Credit Bank was nationalized.

Source: Nihon Keizai Shimbun, Japan Almanac of 1999.

The government, having argued that it was acting to protect the stability of the financial system, intended to inject public money in order to rescue LTCB. But many

details about LTCB's financial condition were not disclosed. Critics charged that the use of public funds without transparency would undermine confidence in government policy and in the financial system. As a matter of fact, under the opposition pressures, LTCB announced that it has 2.82 trillion-yen in bad loans, more than double the amount the bank revealed in May. But many details about LTCB's financial condition were not disclosed. Critics charged that the use of public funds without transparency would undermine confidence in government policy and in the financial system.

Finally, a compromise was reached that in order to deal with the ailing LTCB, it should be put under special public administration. The compromise opened the way for the Oct. 23 enactment of a Financial Revitalization under which LTCB requested that it be put under government control. The Financial Supervisory Agency approved the request and announced that LTCB was insolvent as of the end of September. The other option for the state was to buy up the common stocks of failing banks.

The Financial Revitalization Law is a systematic framework for dealing with bad loans as a key part of its "Total Plan for Financial Revitalization". This plan set up a new agency, the Financial Security Agency (FSA), and when a financial institution goes bankrupt, the FSA will appoint a financial administrator to assume control of the institution. The goal of FSA is to stop the contraction of the supply of credit, and to prevent the *hollowing out of Japan's financial sector* by rectifying the serious lag in deregulation and internationalization. In other words, in order to prevent corporate bankruptcies resulting from bank failures, if no other institution can be found to take over the failed institution's operations, a *bridge bank* will be established. This will be a subsidiary of the (Heisei) Financial Revitalization Corp., a public holding company was established with capital from the Deposit Insurance Corp. The bridge bank was empowered to take over the operations of the failed institution, forming a "bridge" that offers continued credit to borrowers while problem loans are cleared away. In the event of multiple financial institution failures, the system allows for the existence of several bridge banks at once.

In principle, a bridge bank has up to two years to settle its affairs by either merging with a private-sector bank or liquidating its assets. The bank's existence may be extended for up to five years if needed, however. The government has announced an allocation of 13 trillion yen (96 billion U.S. dollars at 135 yen to the dollar) in public funds to provide a source for bridge-bank lending and to cover related losses.

Other than the bridge bank, the total financial strength of the Heisei Financial Revitalization Corp. is a ¥60 trillion package. This breaks down to ¥17 trillion to refund depositors of failed banks, ¥18 trillion for state-run bridge banks or other forms of temporary public control, and ¥25 trillion for possible capital injections into solvent banks. In short, public funds can be used not just to protect depositors but also to sustain banking operations. The money used in the plan will be raised by the government's Deposit Insurance Corp. through bond issuance or government-guaranteed loans from the Bank of Japan and private financial institutions.

The institution is under state control, although it continues to exist as a corporation. One point to be underlined from the viewpoint of power relations is that younger party members of LDP, who have their own ideas about how finance should be handled. In what may be seen as a victory for the younger camp, the new legislation provides for the establishment of a financial revitalization committee that is to be separate from MOF and handle such affairs as certifying the collapse of banks. The committee will also open the road to nationalization for banks on the verge of collapse. Loans continue to be extended to sound borrowers, while bad debts would be turned over to the Resolution and Collection Bank (RCB).

7.6- Assessment of the Emergency Package of 1998

7.6.1- Liquidation of Bad Loans

During 1998, some major Japanese banks have declared that "the end of bad-loan disposals" was at hand. "Disposing of bad loans" refers to writing them off or setting aside reserves. In most cases, the loans have not yet been written off because the underlying real-estate collateral cannot be sold at prices the banks are willing to accept. Moreover, all banks with international operations said they could meet the minimum capital-to-assets ratio of 8% required by the Bank for International Settlements. But they need about 4 trillion yen more to raise their capital-adequacy ratios to 10-11%, the level widely considered necessary to be financially stable and the level maintained by many of their international competitors.

At the end of December 1998, the Financial Supervisory Agency reported that the 17 major private-sector banks had underestimated their bad and questionable loans by at least 5.406 trillion yen at the end of March. Moreover, the agency reported that the

banks were more than 10 trillion yen short of what they should have had in loan-loss reserves. Upon this, more-stricter reporting standards have increased the amount of disclosed bad loans, as has the nation's recession. According to inspection results released by the Financial Supervisory Agency in December, the aggregate bad debt of Japan's 19 major banks totaled 57.3 trillion yen as of the end of March 1998.

Table- 7.16 Profit/Losses from sale of land and property by City Banks
(billion yen)

	Fiscal 1998 (first half)	Fiscal 1997 (first half)
Dai-Ichi Kanyo Bank	56.0	na
Sakura Bank	20.9	3.7
Fuji Bank	19.7	0.1
Sanwa Bank	16.1	1.4
Daiwa Bank	4.2	1.6
Tokai Bank	-0.2	2.2
Asahi Bank	-0.4	0
Bank of Tokyo Mitsubishi	-0.6	-15.6
Sumitomo Bank	-3.1	-7.7

Source: Nihon Keizai Shimbun, Japan Almanac, 1999.

Because of the planned charge off, 13 of the 18 major banks project net losses for fiscal 1998. The aggregate amount disposed of by the 18 major banks from fiscal 1992 through fiscal 1998 was expected to reach about 43.5 trillion yen - 1.8 times the amount of core business profits during that period.

7.6.2- Effects of the Emergency Package on the Economy

Although the government and the central bank made several attempts to alleviate the credit crunch, the effects of their actions did not appear in 1998. As a matter of fact, total lending by all domestic banks declined by 4.7% year on year in December to 508.31 trillion yen, the largest drop since the data became available in July 1991. The drop followed a 4.0% slump in November - a record at the time. Total lending at the end of 1997 by all domestic banks amounted to 503.9 trillion yen.

Nationwide *corporate bankruptcy* liabilities in the first six months of fiscal 1998 grew 33.8% from a year earlier to 7.93 trillion yen, the worst result since World War II (Teikoku Databank Ltd, 1999). The latest figure of October 1999 shows that, the number of bankruptcies rose 5.3% per month and exceeded 1,400 for the first time since

October 1998, when they stood at 1,707. Debts left behind by insolvent companies in August 1999 fell by 7.1% on year to 935.34 billion yen. This figure represents a 31% drop compared with levels in July (NIKKEI, October 30th 1999). As the credit crunch worsened, the government postponed prompt corrective actions until 1999 for banks that have only domestic operations.

Upon the massive bankruptcies, particularly in financial sector, Japanese firms increased their demand for strategic *alliances*. One pattern involves Japanese firms forming strategic alliances with domestic counterparts in other financial sectors to complement their services. Another pattern involves the establishment of joint ventures or other forms of alliances between Japanese financial institutions and major U.S. or European firms. While domestic financial firms look for advanced financial technologies and fund-management expertise in foreign partners, foreign firms see the alliances as a way to tap into Japan's huge pool of individual financial assets, which total more than 1,200 trillion yen.

The foreign competitors moved in as the credibility of Japanese financial institutions was sinking on news of huge bad loans. The bankruptcy of two major banks, for instance, Long-Term Credit Bank of Japan and Nippon Credit Bank, enhanced the negative image of domestic financial institutions. One of the most dramatic alliances forged in 1998 was that between Nikko Securities Co. and Travelers Group Inc., announced in June. Salomon Smith Barney Holdings Inc., a unit of the U.S.-based Travelers financial conglomerate, has acquired a 25% stake in Nikko, becoming the Japanese broker's largest shareholder. Nikko's wholesale securities business was transferred to a new joint venture, Nikko Salomon Smith Barney, in January 1999. The Japanese brokerage will continue to serve retail investors. In July 1998, Merrill Lynch Japan Securities Co. opened the first retail outlet of a foreign securities company in Japan, in the city of Nagano. Merrill Lynch Japan Securities has hired a staff of about 2,000 employees, almost all of whom previously worked for the failed Yamaichi Securities Co.

One of the most serious and striking progresses is that, on October 1999, The Financial Reconstruction Commission announced a new partnership between Ripplewood Holdings LLC, a U.S. led investment group, to take over the nationalized LTCB of Japan. According to the concluded agreement, the new LTCB is expected to be re-launched as early as the start of new year, becoming the first Japanese bank to be

reviewed under the control of a foreign purchaser (Nihon Keizai Shimbun, September, 29, 1999).

Foreign investors are also adding rapidly to their shareholdings in Japan's largest banks. One reason of this surge of foreign interest is that the government's injection of public funds into major banks improved their financial positions enough to convince many institutional investors that the lenders' shares were undervalued. This should be seen a positive impact of the emergency measures in the first quarter of 1998. For instance, at the end of March 1999, foreign investors held, on average, stakes of 7.1% in the nine city banks and Industrial Bank of Japan, up 2.6 percentage points from Sept. 30, 1998.

Moreover, foreign institutions and companies from other sectors pushed into Japan's market for non-bank financial services in 1998, blurring the lines in the marketplace that have traditionally divided leasing, consumer credit, credit cards and other operations. Associates First Capital Corp., the largest U.S. consumer finance company, has also taken control of two non-bank companies: Shizuoka Prefecture-based Nissen, and DIC Finance Co., an affiliate of Daiei Inc. The acquisitions gave Associates First 7.3% of Japan's consumer finance market at the end of September 1998. The average outstanding balance of six major consumer credit companies in the first half of fiscal 1998, which ran through September, showed double-digit growth over a year earlier.

Another response of the firms to the credit crunch was in the form of *restructuring and cost cutting,* as the means of survival. Besides they have applied for public funds to re-capitalize themselves, most of the banks started to cut salaries and to reduce overhead over the next few years. Moreover, consolidation of their overseas outlets and cancellation of overseas operations altogether were also among other alternative means of restructuring. In this process of restructuring and cost-cutting, in addition to the injection of public money along the low interest rate policy, the government also took a set of legal steps to support them in finding more reliable and sound financial sources (Economic Survey of Japan, EPA, 1997). One of them was the cultivation of a market for asset-backed securities. Such securities represent a new vehicle for financial institutions to unload much of their nearly 100 trillion yen in bad loans. Securitization - or the bundling and sale of assets, including bad loans, in the form of securities - has come to be viewed as a final tool to be used to revive the financial industry.

An important step was the enactment of a law in September 1998 facilitating the establishment of special purpose companies. The law lowered capital requirements for establishing special purpose companies and extended tax breaks, providing an incentive to liquidate bad loans. Typically assets are sold to a special purpose company in order to be securitized. Still, cash-rich Western financial institutions gobbled up Japanese properties and property-related loans as fast as Japanese banks offered them in the form of asset-backed securities. Analysts estimated that the amount of foreign purchases of such loans as of June 1998 reached about 4 trillion-yen. The purchases became notable in late 1997 and appeared to peak in the first half of 1998 (Japan Economic Almanac, NIKKEI, 1999). In addition, after the revision of the Anti-Monopoly Law, establishment of holding companies was allowed since 1997. It has been argued that return of the old zaibatsu type of holding companies might have serious negative long-term repercussions on the Japanese economy. This fear is not totally meaningless because they were banned after the World War II as they were blamed for having monopolized the Japanese economy before the war and in alliance with the military class lead the country to the war.

Other than this long-term fear, however, one short-term expectation on the positive side is that the holding companies increase efficiency among financial groups, allowing them the synergy effect of a merger or alliance without the headaches of negotiating with another company. With that expectation, the banks have been forced to recognize the structural changes in corporate finance, as their big corporate clients turn increasingly to capital markets to raise funds instead of borrowing from banks. The percentage of bank loans in liabilities of non-financial corporations declined to 59% in the first quarter of 1998 as compared with 78% in 1993. Corporate bond issuance in Japan surged to 10.5 trillion yen during the January-September period in 1998 as compared with 7.2 trillion yen for the whole of 1997. Despite these alliances, the credit-rating agencies have forecasted that the quality of Japanese banks' loan portfolios will further deteriorate because of new problems as a result of the declining domestic economy and the weakness in other Asian economies.

The result of strong yen appreciation by the third quarter of the 1999 (i.e., $1 = 105.65 as of October, 30, 1999) is to be seen on the performance of the Asian countries and their capacity for debt repayment as well as the surge of their import demand. By the last quarter of 1999, the first sign of the recovery in the Asian economy has been observed. In particular, output of internationally competitive electric machinery,

communications equipment and automobiles is expanding, while consumption has bottomed out. With Japan relying on the Asian economy for 35% of exports in value, economic recovery means a long-awaited boom for Japanese manufacturers (NIKKEI, October, 30, 1999).

A final note-worthy point is the impact of the Big Bang on the employment system of Japan. This subject will be discussed in the next chapter. It is sufficient to note here that, the impact of financial restructuring on the lifetime employment and the seniority wage system seems to have negative repercussions. The process is forcing the system towards reliance more on competitive external labor market and merit-based evaluation scheme, at least in financial services, because the start of the Big Bang increased the mobility of financial industry workers in 1998.

As a matter of fact, deregulation has torn down some of the firewalls between different financial institutions, allowing commercial banks, for example, to engage in the securities business. This has touched off a search for employees with specific fields of expertise new to the financial institutions. Since December 1998, commercial banks and insurers have been allowed to sell investment trust funds over the counter, which has led to strong demand among banks for employees who have experience selling these funds through brokerages. The banks have had to review their wage systems and begin switching from seniority-based pay to merit-based pay in order to attract some of the industry's experts.

Sumitomo Bank, for instance, recruited more than 1,000 personnel for over-the-counter sales of investment trust funds, and 150 of those workers came from the securities industry. Dai-Ichi Kangyo Bank recruited 350 employees, 60 of them came from the securities industry. Other banks followed this trend. For commercial banks and insurers, the investment trust fund is the first financial product with principal at risk, which is why many of the companies felt they needed experienced personnel in place to start up the new business.

Another factor adding to labor mobility in the financial industry was the aggressive sales strategies of foreign-capitalized financial institutions. Merrill Lynch Japan Securities, a specialized subsidiary of Merrill Lynch Japan Inc., recruited 2,000 personnel from failed Yamaichi Securities Co. to start its retail business in Japan. Ironically, the biggest source of securities professionals were the two major securities houses that collapsed in 1997: Yamaichi and Sanyo Securities Co. Sumitomo Bank recruited 110 employees from the two failed companies, and Asahi Bank recruited 30,

most of them women who handle sales. Sanwa Bank also recruited a total of 30 employees from the two failed companies and other securities houses. Nomura Securities Co., the largest securities house in Japan, has been suffering from the increase in labor mobility as commercial banks recruit some of its best and brightest. More than 100 specialists had moved from Japanese financial institutions to foreign-capitalized companies in the fiscal year through March 1998. Many of the personnel who made the moves were from Nomura and Daiwa.

7.6.3- Lack of Transparency in the System

Although legal arrangements and implementations have been severely criticized because of lack of transparency and accountability, looking at the general direction of the reformation process, it can be seen very clearly that this process is akin to bringing about the desired systemic changes and will reduce the destructive entrenchment of the old bureaucrats structures.

The reform of the Bank of Japan, for instance, which was implemented in April 1998, and the proposal of creating new agency to supervise financial institutions has the potential of far reaching consequence for the success of entire reformation process. The key point in the revised Bank of Japan Law is that it explicitly identifies the central bank's Policy Board as the final authority in setting monetary policy. The minister of finance will continue to oversee the central bank and approve its budget, but the scope of external control will be greatly curtailed. The government will no longer be able, for example, to force a reluctant Bank of Japan to make changes in the official discount rate. The revised law also seeks to increase the transparency of monetary policy formation by having the Policy Board release a summary of its minutes as quickly as possible after each meeting (Japan Economic Almanac, NIKKEI 1999).

The long dominance of the Finance Ministry was disrupted and possibly permanently derailed in 1998 by payoff scandals involving ministry officials and the collapse of the "convoy system" as the government took a hard line on weak banks. As we have touched upon before in this chapter, according to the convoy system whenever there is a company that is about to go under, the MOF redirects it under the protection of a larger bank to help it along. At the same time, young lawmakers in the Diet who are well versed in financial policies began taking the initiative in setting financial policy in the second half of 1998.

In the post-bubble period, due to systemic failures and weaknesses, old bureaucratic circles and their alliance with the old and conservative LDP members is going to be shaken with the coming of the new "voice". This means that in terms of mentality, the first sign of an "elite circulation" and systemic transformation is on track. As the number of "exits" increases in the future, and the number of "voices" increases, this means that bureaucratic entrenchment also might be weakened in order to achieve a "fair", "free" and "global" order. The conservative coalition government formed by the LDP and the Liberal Party at the beginning of 1999 might be taken as the indicator of decline in bureaucratic power. One of the Liberals' stipulations in joining the coalition was that bureaucrats would no longer be allowed to answer questions in the Diet in place of ministers. This rule change is planned to take place some time in 1999. Young lawmakers began asserting themselves more in the extraordinary Diet session that began in July 1999. Debates about bills related to the financial sector were conducted without input from the Finance Ministry. In the past, however, the Finance Ministry would set policies and LDP lawmakers who had spent time in the ministry would support those policies. These newcomers dominated Diet discussions of bills to stabilize the financial system. The LDP also had many lawmakers who openly resisted the status quo and moved toward negotiations with opposition lawmakers, leaving the Finance Ministry out of discussions on financial policy. The government and the LDP accepted bills presented by the opposition Democrats after a month of tough debate led by the knowledgeable newcomers.

The establishment of the Financial Supervisory Agency should also be seen as the indication of loss of power in the MOF, and in the bureaucratic cadres, in general. Japan's financial regulations in 1998 started with the establishment of the Financial Supervisory Agency, which took over from the Ministry of Finance the job of supervising and inspecting financial institutions. The ministry retains authority for designing policies for the financial system and securities industry. Authority to solve problems of failed financial institutions - such as issuing corrective orders, suspending business and approving mergers - now rests with the agency. But in cases where the commissioner determines that the consequences of the agency's actions that will seriously impact the nation's financial stability, he may consult with the Ministry of Finance to draw up measures aimed at stabilizing the financial system. In 2001, the Financial Supervisory Agency will be reorganized and it will additionally assume the functions of planning and formulating policy for the financial system.

The agency faced formidable tasks and challenges from the outset. It began inspections of Japan's then 19 major banks in late July 1998. Its findings showed a worse picture than drawn by the self-assessments made by the banks of their condition at the end of March 1998. LTCB asked the government to place it under temporary state control on Oct. 23. The Financial Supervisory Agency released that same day its findings on LTCB, which showed the bank to be insolvent. The agency was criticized for not having acted sooner. Since late June, the agency had tried to co-ordinate a merger between LTCB and Sumitomo Trust & Banking Co., and Commissioner Hino had repeatedly denied rumors of LTCB's insolvency. The merger talks fell through upon LTCB's nationalization. In contrast, the agency acted with speed and resolution that surprised much of the financial community in pushing for the nationalization of Nippon Credit Bank in December. The agency concluded on the basis of its inspection that the bank was insolvent and would be unable to re-capitalize on its own.

The Financial Reconstruction Commission, the public body responsible for revitalizing the financial system, was established on December 15, 1998. The commission's role includes formulating measures to deal with bank failures and to re-capitalize sound banks, based on the financial revitalization legislation enacted in October 1998. The commission screens the restructuring plans that banks submit and acts on their applications for public funds.

7.7- Conclusion

In the pace of recovery, the general observation is that the Japanese system, at least at this stage, is on the way of converging to the western style market economy. The weakness of the Japanese financial firms and the legal arrangements of the state not only motivated foreign participation, but also it seems that the infrastructure of a competitive economy is being established in terms of transparency and accountability. That is, despite the existent criticisms towards the current reforms in terms of timing, sequence, scale, scope, and consistency of the policies, it is undeniable that the process is going in the right direction.

VIII- THE END OF JAPAN'S DEVELOPMENTAL MODEL:
A Search for Institutional Shift in Japan's "Consensus-Compromise Paradigm"

8.1- Introduction

As Japan's post-bubble economic crisis worsened towards an economic depression, economists, including even the strong proponents of the 'Unique Japan' hypothesis, have started questioning the relevance and the sustainability of the "1940 setup". After periods of strong economic growth, the vital question remains as to how Japan moved from being a country that many developing countries tried to emulate to being yet another major economic power in distress.

In this chapter I will analyze the current economic crisis from the viewpoint of Japan's developmental institutions. In performing this task, the ideology behind these institutions, the infrastructure of their legitimacy and the institutional characteristics of Japanese incentive scheme will be focused upon because they constitute the basis of the post-second world war developmental paradigm. Moreover, in performing this task, the basic features of Japan's developmental model, as they are explained in chapter four, will be reconsidered in order to show the nature of Japan's institutional crisis.

As we have explained the progress of developmentalism in chapter four, it will be referred to here in terms of its role in organizing and institutionalizing institutional links and networks between economic actors and the emerging "principle-agent" problems. A strong consensus at the top of the system, between the trinity of politicians, big business, and bureaucrats, and an "engineered" compromise at the lower strata of society was achieved after the second world war. This feature constitutes the first prominent feature of the post-war system. Having considered this facade of the argument, I have also shared the idea that the Japanese system is the outcome of a consensus among the iron triangle.

To remind, briefly, once again, the first element the established consensus around the developmental paradigm is the reliance on *pro-production* priorities. The second related element is to achieve the possible *fastest growth,* because it was believed that it would generate *employment and income*, which constitutes the third element of the so-called consensus. Fourth, a special emphasis on export performance has been given in order to generate the necessary foreign exchange to finance import. It was proposed that in this transmission mechanism between growth, employment, income,

and export there is a virtually reinforcing positive and prolific dependency, which would guarantee success of the developmental paradigm. The other motivation behind heavy emphasis on growth was the historical drive for catching up to the industrialized countries, which provided the last, but not least, element of the consensus paradigm. What I have discussed in this study until now is that all these institutions and policies have been designed according to the requirements of this developmental model.

8.2- Repercussions of the System

8.2.1- Demise of Developmental Institutions

Based on this perspective of the system, a consistent system emerged, which was widely accepted as the elements of the "unique Japan". It has been shaped by a set of micro and macro level institutions (Levine, 1987). These elements were the employment practices such as lifetime employment, seniority-based wage system, and company-based labor unions; cross-share holding system according to which influence of shareholders on corporation has been weakened and increased the long-term vision of and autonomy of the entrepreneurs; an indirect financial system which solved the problem of capital shortage and eased the long-term competitive strength of the firms; government industrial policy, which established legal and institutional infrastructure of a competitive, foreign-trade oriented strategic industrial structure; government structure in which local governments are strictly controlled by the central authority (Noguchi, 1998, 407). They constituted the basis of Japan's scheme of motivations, and they proved their "effectiveness" in the course of Japan's catch up process until the 1980s, and as we have noted before, Japan's developmental ideology derived its legitimacy from its materialized successes through these institutions. In the previous chapters, their contribution to the Japan's development has been exposed in detail. In the rest of this chapter, however, these elements and their impact on the systemic enigma will be discussed.

One of the most prevalent repercussions of the system can be seen in Japan's foreign trade patterns and structures. Since the overall success and the stability of the system has heavily depended on the high performance of foreign trade strength, all the necessary measures were taken and the industrial structure has been manipulated so as to guarantee international competitiveness. In order to do that, not only the established

domestic consensus, but also "exceptionally" available international order mutually fostered this system to be a viable model of development. Later in this chapter I will return to the foreign trade issues in detail in order to show how it has lost its relevance for the survival of the system, even worse, it turned out to be a destructive element in terms of loss of competition, high price structure in domestic market, low productivity in the non-export oriented sectors, and corruption because of the established interest coalitions behind the protective walls and long-lasting political stability of LDP.

What I would like to note here is that the fast-growth era of Japan between 1960-70 was identified increasingly by the institutions that would foster a stable and continuous setting for maximum saving, investment, and export. We have shown in chapter four how developmental polices enforced the Japanese or made it inevitable to increase household savings as the stable, reliable, and cheap domestic source of growth. The story of "investment race" in the 1950s in large-scale industries where heavy capital is required and the surrounding industrial institutions and polices were explained in chapter five.

To repeat myself briefly here, in order to create domestic winners and champions in the world league, particularly in the strategically chosen sectors, the domestic market was sheltered from foreign competition and the organization of economic activity was highly manipulated. Moreover, production was reinforced through the concerted efforts of the bureaucrats, despite the cost of it was paid by the entire Japanese populace. The pro-production policies were implemented with the principle of anti-competition principle. With the passage of time, however, this anti-competition tendencies has been internalized as one of the endogenous values the system, and it was rationalized with the argument of "Tokubetsuna Nihon", or with "Japan is different" calamity. It is because of these values remain so deeply ensconced in the national psyche that all the noise about deregulation and putting the consumer first has failed to produce any results. As a matter of fact, unlike American capitalism, in Japan, "producer sovereignty", not the consumer, dominated, as the other repercussion of the system. Few spoke out, for instance, against the idea of plowing the profits of increased productivity back into the company to make it grow more rather than spreading them around through higher wages. Even labor unions moderated their demands for wage hikes (Groenewegen, 1997).

What intellectually planted in Japan was that enrichment of human life would result from economic growth, and indeed that economic growth provides the only way

for life to be enriched. Consumption was equated to an evil waste and calls for a higher standard of living were considered an indication of laziness. Properly speaking, initially the reinforcement of the production capacity was seen as means, not an end. Nevertheless, as we will argue later in this chapter, it has become evident that this reinforcement has gone on long enough so that the illusion has already spread that increased production itself has some ultimate significance or value. That is, it was declared as the "means", but it has ended with an "end" in itself. In the case of the production-first principle, it went so far as to be seen as a universal value. This sort of value meshed neatly with the "work comes first" attitude that became the company-centered ethic and behavior of the postwar period, according to which the Japanese people should work together with a single purpose. To this end, great attention is paid to teamwork and equitable distribution of results of the collective efforts. In this surrounding, not only foreign competition was isolated, to a certain degree, internal competition tends to be negated in certain fields where in it was feared that "social harmony" is harmed. But the overriding objective is not to let anyone fall behind. The 1940 setup as a whole is, in this sense, a vast social security system.

As evidenced by the word "excessive" placed so often before it, competition has come to be thought of generally as a bad thing. We have discussed in chapter four that by the turn of the 1920s, Japan had an undesired experience of an excessive competition which left its print on the whole industrialization experience of Japan. In that period, because of the massive entries in order to reap the high profit opportunity, there was an excess competition in Japan's major export sectors such as textile and silk. This competition resulted in an over capacity syndrome and, in turn, led to the drastic decline of profit margins, a process which resulted in massive bankruptcies of small and medium-sized enterprises. As the overwhelming majority of employment took place in the bankrupted industries Japan experienced continuous social turmoil around 1920s.

Against all of these developments, only the Zaibatsus type of big business enterprises could successfully resist and survive not only because of their accumulated capital stocks, but also because of their collusive behaviors and clientalistic relationships with the bureaucracy. As a result of this, Japan passed through deep social chaos until the outbreak of the Great Depression in the world economy, soon after which Japan entered an imperialistic expansion in the international system and military fascism within the country. Industry privileges, then, were put under the service of a war-oriented economy, and therefore competition was eliminated from the system.

Generally speaking, beside this historical experience, the philosophical idea behind this thinking is that competition is a one-sided principle favoring the strong and ignoring the weak (i.e., the strong fish gobbles up the weak) and therefore it should thus be eliminated from the system to preserve social harmony. Coordination and coexistence, therefore, have come to be viewed ideal. Accordingly, equal outcome to each, rather than equal opportunity according to personal capacity and capability, was privileged.

From a neoclassical viewpoint, production is subject to market forces, and ensuring people's livelihoods should be the function of a social security mechanism. In other words, individuals should be guaranteed the right to survive and make a living, but not the right to keep a particular job. The developmental perspective, however, differs from this in that it seeks to guarantee the survival of producers, as well as employment. This is justified with the argument that because business enterprises are viewed as the basic unit of society. Policies dealing with agriculture, for instance, have sought to support not the quality of life in farming communities but the people engaged in the industry of agriculture. The same can be said for policies concerning distribution and other service industries, where restraints on new entrants have been implemented to support the position of those already doing business. One recent example of a failure in this thinking was introduced in the previous chapter. There the so-called "convoy system" has been discussed, according to which all institutions should move in the same direction altogether. The same mentality can be observed in the financial sector as well. Measures were taken there in the name of "protecting the depositors" which were actually meant to enable financial institutions that had reached their limits to continue operating.

What these systemic repercussions would mean from the view point of institutional interpretation developed in chapter three? Having considered the path-dependent nature of economic activity, empirical studies pointed out that behavioral patterns of economic actors can and even should be molded so as to improve market outcomes. As Polanyi (1944) has shown, markets are instituted processes, and they are unlikely to function well in a vacuum. In fact, institutions evolve under some specific historical and social conditions. That is, society itself is an amalgam of institutions including government, families, banks, corporations, codes of law, religious foundations and so forth. Behavioral patterns of economic agents, therefore, are shaped in the context of such cultural and institutional structure. In that sense, economy, market, and

economic development are intermingled and are instituted processes (Pepelasis, Mears, and Adelman, 1961, 161).

North (1989) has also shown the role of institutionalizing economic activity so as to minimize transaction costs. The "embedded" nature of institutions, however, lead the relative subjectivity of perceiving, evaluating, and internalizing economic outcomes in a given context. For instance, the "equal opportunity for each" as the dominant principle of democratic industrialized counties of the west was firmly rejected in Japan's developmental model and, instead, "equal outcome to all" was strongly emphasized. This as combined with Japan's rejection of "excessive" or "destructive" competition, which implies the Western notion of the Darwinian "survival of the fittest" and was perceived as unfair and non-humanitarian because it would undermine the "communitarian" values of society and in the long-term keep society together. Or to put it in terms of Smithian terminology, the Japanese do not believe that self-interest seeking activities or utility maximization of each individuals would necessarily overlap with the public interests.

For instance, context-dependent nature of interpreting economic activity can best be seen in the way of Japanese performance measures. Within Japan's corporate environment, for instance, performance is not measured solely on the basis of material output. For example, an employee would contribute to the firm or the neoclassical principle of an equalizing marginal product and the marginal cost, but neither has been well-come. Instead, in Japan after the principle of "work comes first", individuals are expected to do their best (*gambarou*) and their performance evaluation is made on a set of multiple criteria such as "obedience", "self-esteem", "loyalty" to the company culture and so forth. Accordingly, the outcome of the "collective efforts" should be divided equally among the team (*ringi*) members. Amartya Sen (1987), an Indian nobel-prize owner, suggests that in order for neoclassical economics to enhance its coverage of other experiences and to keep its validity as a scientific paradigm, the definition of rationality should be extended beyond its current emphasis on short-term utility maximization, which excludes different experiences beyond its scope. As North (1990) has shown in his historical observation, in understanding of the role of institutions in economic development and transaction cost minimization, the question is not whether institutions matter, but rather how institutions matter in terms of the incentives and disincentives they present to actors.

From a neoclassical point of view, the Japanese style institutional path has been under criticism. Japanese industrial policies, for instance, have been criticized as having dried out resources from most productive uses and dynamic sectors to the inefficient industries especially after the two successive oil crises, because of Japan's desire to keep employment, not to allow any losers, and therefore restrict competition (Katz, 1996). This is a different point to be discussed which I will return to it later. What I am trying to note is the existing "perception gap" between different cultural contexts in legitimizing any system and its continuation in a given setting. I would like to note one other example to clarify my point further. As Friedman shows in his analysis on the Japanese flexible production model, the dualistic structure of Japan both in the labor market and in the manufacturing industry is the necessary outcome of the Japan's industrial policies. Nevertheless, it was legitimized on the basis of the Japan's developmental framework as has been exposed so far. Within the framework of Japan's developmental model, Japan's rational of choice of this mode of production might have useful suggestions in understanding the nature of the "systemic cost" and the future course of Japan's reformation. For Friedman and Patrick, the choice of mode of production is not only related to the availability of technologies and factor of production in terms of quality, abundance, and costs, the "choice of a type of production depends (also) on how people evaluate the market context around them. Also the definition of sets of beliefs and rights affecting permissible industrial choices can be referred to as "politics". And finally that definition results from struggles throughout society to work out a systematic way of structuring social relations" (Friedman, 1988, 25). In fact, "this can be observed specifically in the expansion of small-scale firms pursuing flexible strategies, the resolution of conflicts regarding heavy bureaucratic influence, influences of government involvement and their effect on the allocation of resources. Without considering this perspective, it would not be possible to understand the Japanese wide-spread dualism as a complex, comprehensive, and social phenomenon which lead to radically different social consequences rather than economic outcomes only" (Patrick, 1976, 6).

The reason of the current emphasis on the issue of legitimacy is that, in analyzing any set of principal-agent relations, we should ask different questions and use different hallmarks other than their western counterparts in order to understand how conflicts are resolved and why Japanese participate in a particular system despite they are not rewarded in the sense of western people expect or assume as rational. Because

Japanese understanding of rationality differs from the western counter parts, any criticisms were directed to the Japanese institutional settings and their functions have been founded irrelevant by the Japanese to their historical and societal trajectories of development. In that context, it might be highly useful to stress the way of these institutional practices have been "legitimized" throughout the society.

It would be much more practical, and even fair, to evaluate the system in terms of the output that it has produced, which are not necessarily in terms of material outcomes that can me measured. Even in terms of material outputs, the Japanese system was being praised not only because of its international competitive strengths, also for its achievements in terms of its distributing outcome of fast economic growth in a fair and equitable way among the participants of the system. The "distributive efficiency" of the system, and the creation of a "middle-income society" was proclaimed, popularized, and even propagated by the western scholarship (i.e., Vogel, 1979) as well as the Japanese (Sakakibara, 1993, Ozaki, 1991) as the explicit indicator of superiority of the Japanese style "human-faced capitalism" over its western counter-parts.

8.2.2- Toward Visible Sings of Japan's Enigma

In order to understand what happened to this system and what has become an unbearable burden over the whole society deserves further explanations, again on the basis of the system's basic elements. As I have mentioned above, the foreign trade orientation has been one of the guaranties of the survival of the system. As export performance of the industrial structure was seen as the necessary requirement of achieving some developmental targets such as, fast growth, high and equal distribution of income, employment guarantee, and foreign exchange surplus to finance imports has been internalized as one of the persistent features of the system. As I will try to show below, this strong systemic priority has been so strong and persistent that despite such a foreign trade paradigm has lost its relevance recently, it has continued its dominance and started drugging the system into its own waves.

As we have also showed in chapter five, industrial policies, in general, and infant industry protection, in particular, were perceived as the legitimating framework of necessary linkage between the creation of a desired industrial structure and foreign trade performance. The infant industry protection and "choosing the winners" was formulated in terms of its growth potential to achieve economies of scale, learning by

doing, and inter-industry positive externalities, income elasticity of demand, and productivity increases. We have seen that Japan, taking the advantage of its strong bureaucracy, developmentalist institutions, and the available international order, has been very effective in implementing her industrial policies through the guidance of MITI and MOF.

At the same analysis, we have also mentioned the skepticism and reservation of Mill, Bastable, and later Johnson in pointing out the difficulties associated to the infant industry protection. To remind once again, these points were closely related to the terms and duration of protective measures. In qualifying protection, the question was that would these temporarily sheltered industries be able to get rid of their "historical handicaps" and achieve competitive strength when they are exposed to international competition? Will the discounted value of protection, at least, replace the cost of the present protection. This is a logical question because there is no ex-ante guarantee of future competitive power of these sheltered industries due to a set of interrelated reasons, such as they might not be able to internalize the culture of free competition behind protective walls and as they get stronger they might demand further and continuous protection in order to preserve their established beneficiary status at the expense of the whole society. As I will try to show later, Japan was caught in this trap and society has been forced to subsidize export performance for these sheltered industries with heavy capital investment despite the secular decline in their profitability. Currently, with the burst of the bubble economy in the 1990s, there is an increasing call for continuous compensation because the number of losers suddenly increased, as the pace of deregulation measures in finance has progressed.

An equally important drawback of "choosing the winners" was that "although government's industrial policies succeeded in shepherding Japanese companies into dynamic sectors, they were, however, used principally to help Japan catch up. What is obvious is that picking the winners and losers in a less developed and relatively small economy is surprisingly straightforward. What must be done is simply to adapt and to copy the leader's high-growth industries. Once Japan achieved a leading economy status, however, the choices became much less clear" (Crawford, 1998, 181). In fact, as we have discussed before, several successive industrial policy failures under the "visionary" guidance of MITI around 1970s have gaven a policy message that countries likely to remain a brilliant followers, synthesizing and improving upon the work of others but struggling to make leaps of invention of its own.

Having given special reference to Johnson (1992)'s distinction between the neoclassical short term efficiency criteria in allocating resources to their competing uses, and effectiveness in the process of making strategic choices, we have tried to clarify long-term implications of emphasizing on "strategic choices". As Calder (1988) also argues, "efficiency" criteria and "effectiveness" are not necessarily consistent with each other, especially as production cycles reach maturity. More concretely, what the Japanese have understood by the term of effectiveness is to achieve competitive strength over their foreign rivals and achieve maximum market share, even at the expense of loss of profitability. This strategy has worked comparably well when the Japanese firms were operating under full capacity and there was a word-wide growing demand for their products. After their product cycle reached to that of maturity and an over capacity syndrome have emerged in global capitalism, the concept of efficiency praised by the western paradigms has strongly dominated the concept of effectiveness praised by the Japanese.

In other way around, in Japan's industrial policy paradigm both pro and anti growth elements co-existed from the very beginning. Pro-growth factors promoted strategic industries, whereas anti-growth elements intended to prevent any failures and losers in order to preserve employment and incomes even at the cost of industrial advancement. Initially, domestic and international order were available, and therefore, pro-growth elements dominated when country was in catch up process, whereas with the passage of time parallel to Japan's mature production cycle and changing nature of world trade and production environment, the anti-growth elements started dominating. In other words, the over-emphasis on the effectiveness is closely related to the strategic choices. Strategic choices in turn were privileged in order to enhance national economic interests, on the one hand, and distributive privileges dominated by clientele-type of collusion in order to compensate economic losers in order to keep social and economic conform, on the other.

8.2.3- New Challenges and the End of "Catch Up" Model

By the end of the catch up process at around the 1980s, and serious external shocks magnified Japan's already fragile system. For the past century and particularly after the end of World War II, Japan focused the bulk of its enormous energy on equaling or surpassing the United States in industrial and technological capability, particularly in

industries such as steel, autos and computers that were considered strategic. Growth in these industries requires enormous investment, and because Japan did not want to accept foreign investment, the money had to come out of domestic savings. Thus, Japan adopted a number of policies and practices such as low taxation of interest earnings, the semiannual bonus system and curtailment of consumer credit mechanisms, all aimed at inducing its citizens to save. We have discussed the impacts of developmental polices on the saving behavior of the citizens in chapter four. In chapter five, on the other hand, while discussing the implementation of industrial polices we have also discussed how the savings were funneled through the government-guided banking system and invested in the targeted industries.

What should be clear from the discussions in chapter four and five is that, it was believed around the 1950s that to achieve a worldwide competitive industry, the new factories had to have world-scale manufacturing capacity. Along this line of thinking, large-scale heavy capital investment had to be maintained along the post-war period until now. Because domestic demand at the time was not great enough to justify such capacity, emphasis had to be placed on selling the excess capacity in export markets. Thus, an array of policies aimed at promoting exports were adopted. At the same time, domestic markets were largely protected in order to assure maximum utilization of domestic capacity. The model worked better than anyone could have predicted for several reasons. First, as Japan was behind in technology, targets were easy to identify simply by looking at what the U.S. had. Nothing new had to be invented, and development was largely a matter of obtaining licenses and know-how. Second, the Japanese economy was very small compared to the size of the U.S. and European economies. This meant that Japanese exports initially had little impact on the larger economies. Thus, the export-led growth model was given a lot of room to expand. Third, the circumstances of the Cold War were extremely favorable to Japan. The U.S. government encouraged technology transfer to Japan, accepted an under-valuation of the yen, kept its markets open to increasingly large waves of Japanese exports, and relieved Japan of responsibility for its defense and much of the conduct of a normal foreign policy. As Gao argues "the success of developmental policies and institutions depended on the capacity and willingness of the United States to absorb Japan's huge exports of manufactured goods without strongly demanding a balance of trade in exchange for Japan's support in containing communism" (Gao, 1997, 303).

In this hot-house environment, and with the enormous effort and skill of the Japanese people, the Japanese sapling grew rapidly into a giant tree. Having combined this external situation with domestic institutions and the grand alliance between politics, bureaucrats, and the big business, Japan has been capable of taking advantage of being a late-comer country (Sato, Shumpei, and Yasusuke, 1979, 444). As Sato (1996, 15) argues, "from a longer-historical perspective, Japanese developmentalism and its institutions should be considered as the pragmatic response of the catch up drive. Indeed, so successful did the Japanese model become that it became the widely imitated paradigm for the rest of Asia".

There were also other heritages of the 1970s decade on the economy after 1980. By the mid-1980s, however, circumstances and the internal logic of the Japanese system had changed dramatically. Japan had truly caught up and was now at the leading edge of industrial know-how and technology. While this represented success, it also meant there were no longer any obvious targets. In the past, development had been largely a matter of bureaucrats working together with business to marshal the necessary resources to create a Japanese version of an industry or technology that already existed somewhere else. Now Japan had to begin doing basic research for itself where technologies and products were likely to be winners. This was a task that required less administrative guidance and more entrepreneurial endeavor than was normally the case in Japan.

8.2.4-Japan's False Response to the External Shocks

The bright picture of Japan was, first, bloodshot after the American suspension of backing the Bretton Wood system. Two other successive shocks came with the oil crisis. Japan's response to the first and second oil shocks was discussed in chapter five. We have argued there that in order to eliminate or at least minimize its negative repercussions and reduce Japan's heavy dependence on energy, Japan has undergone a serious structural transformation towards much more dynamic, high-technology, and knowledge-intensive sectors. We have also argued there that not only the role of MITI has changed but also the nature of industrial policies changed under domestic and international pressures. This does not, however, mean that Japan left its traditional industries or exposed them to the international competitiveness. Rather contrary, under the guidance of MITI, Japan established several recession cartels in order to preserve and protect the old industries. For instance, the losers were not allowed to exit from the

market and instead of leaving less flexible industry's fate to the market forces, Japan preferred to protect noncompetitive industries such as construction, energy, transport, distribution and telecommunication under the roof of recession cartels. Katz and Woronoff have criticized because, instead of national interests, they protected collective interests of the existing beneficiaries, to be discussed later in this chapter (Katz, 1996, Woronoff, 1996).

What should be noted here is that although Japan's response was consistent with the "old paradigm", this paradigm, however, had shown signs of its irrelevance to the new realities. For instance, after Japan's second weak response to the oil shock and the recession associated to it, to stimulate economy by shifting foreign demand to domestic goods and therefore by exporting its recession to foreign countries, Japan first, devalued the yen, and then pursued excessive deficit spending policies until early 1980s.. Judging from short-term measures, these policies became highly successful in the sense that, for instance, as was shown in chapter seven, between 1980-1983, 35 per cent of Japan's GNP growth came from external demand.

Under the illusion of such "pragmatic choices", it was believed that Japan overcame the problems of the oil crisis in the world economy. That is why, Japanese recession cartels became very popular as one of the "unique" aspects of the Japanese system. But as will be discussed in the rest of this chapter, "gist of the Japan's solution was that they were no solution" (Akyüz, 1996, 22). They were rather sort of a "policy inaction" which extravagated the depth of the problems.

In the wake of the twin disasters of yen revaluation and the oil crisis during the 1970s, the Japanese economy emerged with radically reduce prospects. Despite its impressive response to new, unfavorable structure of international cots, the Japanese economy could secure no recovery of profitability and could re-launched no sustained investment boom, because it proceeded along the same manufacturing-focused, export oriented trajectory as hitherto. As a consequence of the exceedingly slow growth of its prices, attributable in part to its restrictive, anti-inflationary macro policy, and the extreme difficulty of penetrating its imports markets in manufactures due largely to the multiple networks that linked its firms as one other's semi-permanent customers, Japan tended to run ever greater trade and current account surpluses, which sooner or later would drive up the yen and raise Japan's productive cost in international terms. Because, moreover, of the already existing international over-capacity and over-production in manufacturing lines the improvement of US competitiveness and the rise of new

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adversaries in East Asia, Japanese manufacturers firms themselves were under increasing pressure from their rivals in international markets. The Japanese economy was therefore able to maintain its manufacturing export-oriented path only by accepting much-reduced levels of manufacturing profitability.

A celebrated export growth appeared paradoxically in light of the sharply reduced growth of the world demand that accompanied the international crisis. Because of their tendency to rapidly build up fixed capital and to do so on the basis of debt, as well as their difficulty in shedding labor, Japanese firms needed to maintain output and capacity utilization at almost any prices. Although there was a sudden stagnation in the world markets and international competition intensified rapidly, the Japanese firms had underwent a pressing need to continue their operations and sale at about any price in order to make use of the capital stock that they had only recently so vastly expanded and a labor force that they could not be easily lay off, Japanese manufacturers simply had no choice but to keep a lid on the prices of their mostly tradable goods to maintain output and sales.

In the context of reduced capacity utilization, increased labor hoarding, and slow down in equipping workers with new plants and machinery, the growth of Japanese labor productivity in this era actually turns out to be rather good. The relatively impressive performance of the Japanese labor productivity was made possible through more efficient and more intensive application of labor. Declining competitiveness was the result of radical increases in relative wage costs which were brought on by successive waves of yen revaluation, by the sharply increased energy costs and by the entry into the world market of low priced manufacturers originating in East Asia.

The organization of much of the economy into horizontal and vertical networks linking banks to firms and firms to one another also played a major role in the transformation. To start with the "seemingly" good aspect of this institutional response, since firms within the groups constituted a large degree of the markets and since they informed one another of their investment plans, they were able to reallocate investment towards new lines with high degree of security and speed. The close ties maintained between great firms and in an between groups with their subsidiary suppliers contributed to the same effect. Moreover, the most crucial, by virtue of their close relationships with their banks, Japanese firms enjoyed enormous advantage in terms of success to finance over their major oversees rivals.

Despite their sharply reduced profitability, they could be sure of ample funds from their banks creditors-partners to carry out new projects, and could count on the banks and firms which held to their side. They were therefore able to sustain investment plans in the face of declines in corporate profitability that would probably have provoked the cut-off funds from outside investors in much of the rest of the advanced capitalist world. They could, moreover, expect to be able to borrow at low-interest rates by international standards, as households' high propensity to save continued to yield a steady supply of cheap funds.

Between 1975 and 1981 the share of total manufacturing investment allocated to technology intensive lines grew by 42 per cent while the share apportioned to other manufacturing investment fell accordingly. Over the years 1973-80 output in the advanced electrical machinery and precision instruments industries and in other processing industries grew at average annual rates of 15 per cent and 6.2 per cent, respectively, compared to just 4.6 per cent in the heavy chemical, petroleum, metal industries, and 3.6 percent in the labor- intensive textile and food industries. Between 1971-81, the shares of general machinery, electrical machinery, and transport equipment in total exports increased by 50 per cent, 25 per cent, 20 per cent respectively, while those of textiles, chemicals and primary metals fell by 60 Per cent, 30 per cent, and, 25 per cent respectively (EPA, Economic Survey of Japan, 1996-97).

To put in other way, the inability of Japanese manufacturing sector to achieve a greater recovery in profitability in the years following the oil crisis was thus largely the result of its inability to impose greater mark ups, the consequence, in turn, of its declining ability to maintain competitiveness while it increased its export dependence in an epoch of international manufacturing over capacity and over production. More concretely, when the U.S. authorities implemented a deflationary policy in response to its own twin deficits from 1979, and a new round in oil price increase soon followed on, the Japanese government saw little choice but to follow suit. In the 1980, domestic demand slowed sharply and later export growth fell sharply as the U.S. market collapsed with the onset there and throughout the advanced capitalist economies, of a new serious recession. The Japanese economy had entered a cyclical downturn of even greater length, though, significantly lesser depth, than that of 1974-75.

From 1982-83 onwards, as between 1974-75, a combination of US record level government deficit and fast rising dollar pulled the Japanese economy from recession to draw a new cyclical up turn, lead by export but limited in its dynamism.

Between 1982-86, a record level of deficits have been observed in the U.S. trade and current account accounts. Moreover, Japanese exports to the U.S. grew at a spectacular average annual rate of 23 per cent at the same period. In just these four years, Japanese exports to the U.S. as a percentage of the total Japanese exports grew by almost 50 per cent. By 1985, Japanese exports as a percentage of GDP, at 11.1 percent as recently as 1979, had grown to 14.5 percent, while manufacturing exports as a percentage of manufacturing output, at 35.6 percent in 1979, had grown to 47.7 percent. The current account surplus, at 0.4 of GDP in 1981, had risen to 4.2 percent of GDP in 1986.

The Japanese government, taking the opposite course to that of US, repressed the growth of domestic demand by embarking on the extended campaign to reduce spending and balance the budget. Between 1980-85, Japan reduced its government deficit from 4.2 percent of GDP to 0.8 percent of GDP. At the same time, in response to the record – high US interest rate that had brought about the super high dollar, Japanese money poured into US treasury instruments, and was thereby rendered unavailable for productive use in Japan itself. Given the still unresolved problem of reduced profitability in manufacturing on a wold scale, stimulating demand was clearly becoming ever more contradictory and difficult process. That is, by incurring record deficits, the U.S. government powerfully increased the demand for Japanese exports; but it could finance those deficits only by raising domestic interest rate and tapping into the Japanese surpluses, they under cutting Japanese domestic investments.

The money regime was to fundamentally reoriented to the pattern of the Japanese economic evolution. It hoped to increase radically the assets of Japans' leading industrial firms so as to enable them to carry through the formidable tasks not only of raising export competitiveness by another order of magnitude, but also reorienting the Japanese economy away from export toward the home market. The banks were supposed to channel the government's increases in the supply of money to investors who could be expected to buy stocks and lands, driving up the value of these assets and reaching the corporations in the process. The rest of the story which lead to the runaway speculation in the land and stock prices has been explained in chapter seven. In this process, real estate companies borrowed massively to buy land with the intent to sell at a higher price, consumers reduced their savings rate and stepped up their spending, and residential construction boomed.

Corporations appear, at first, to have used the massive increase in the value of their stocks and land to reduce their reliance on debt finance, as well as to engage in

financial manipulation, raising funds very cheaply in money market and depositing them at higher rates of return in interest rate deposits. But eventually, as had been hoped, the corporations took advantage of the growth of consumer demand, as well as the enormous increase in their wealth, to carry through a waive of plant and equipment investment on a scale not seen since the 1960s. As a response to the state sponsored speculative bubble economy, manufacturers made serious efforts to improve and transform manufacturing so as to maintain exports in the face of new rise of the yen after 1985, much as they had during the years of currency revaluation of mid to late 1978. Between 1985-91 they maintained an average annual rate of growth of the gross capital stock of 6.7 percent. In the same years, Japanese producers raised their expenditures on research and development as percentage of GDP by about a quarter, compared to that for the years 1980-85. The average annual growth of hourly manufacturing labor productivity in these years in Japan was thus about 5.4 percent, compared to 2.2 percent in the U.S. (Van Ark and Pilat, 1993).

As an integral part of its developmental push, Japan had succeeded by the end of the1980s, in increasing the proportion of its manufacturing output that was either high-tech or mixed high-tech, and capital-intensive to about 85 percent, catching up in the process with the U.S. in its degree of specialization in high-tech and high-wage lines, and becoming even less specialized than was the U.S., in low wage and low tech production.

At the heart of the problem faced by Japanese manufacturing was their declining accessibility to the critically important US market because the Reagan Administration had introduced so called voluntary export restraints on a set of selective Japanese goods such as automobiles, the yen's appreciation after the Plaza Accord of 1986, and eventually, Japanese producers found themselves confronting a protected market with much more costly exports. As a result of them, Japanese exports to the U.S. as a proportion of total Japanese exports fell from a peak of 40 percent in 1986 to 31.6 percent in 1990. In part, Japanese producers responded to their declining ability to export to the U.S. simply by seeking markets where they were less disadvantaged by yen revaluation since the yen rose so much less against European currency than against the dollar, Japanese exporters were able to increase their exports to Europe by 168 percent in dollar terms between 1985 and 1990.

The decisive new departure, however, was tied to a stepped up FDI. The Plaza Accord turned out to be turning point in Japan's overseas investing. Between 1985-89,

Japanese foreign direct investment tripled in terms of yen and grew by a multiple of six in terms of the dollar. Between 1985-90, it was more than 10 percent greater than that of the U.S., and almost double that of the U.S. between 1987-1990. The following factors can be cited among the reasons behind this surge of FDI: First, to escape import barriers; second, to take advantage of cheap and qualified labor in the Sout East Asian countries; third, to take advantage of the triangular trades linking Japan, East Asia, and the U.S.. By this way, Japan not only took the advantage of the dynamic factors in the Asian countries, but also got the advantage of indirect access to the huge American markets.

8.2-5- Japan's FDI Movements and the Hallowing Out of Industry

When the FDI movements of Japan are analyzed in the post-1980s, it is observed that different influences have been at work at different faces of the expansion of Japanese FDI. In the first half of the 1980s, FDI and domestic investment were largely complementary and FDI was trade enhancing, while in the later period, FDI has emerged as a substitute for domestic investment and replaced rather than added to Japanese manufacturing exports. This evolution of Japanese trade and FDI has been greatly influenced by a number of macroeconomic development in Japan and its major trading partners. Disparities in the growth of the major markets, the pattern of the exchange rates, and protectionist pressures combined to promote both Japanese FDI and exports (Inui, 1997).

In the Japanese model, FDI has been governed by the evolution of macroeconomic comparative advantage patterns between the host countries and Japan. Domestic investment disappeared in those sectors suffering from loss of competitiveness and production was relocated where labor was cheaper in order to supply both foreign and home markets. However, aggregate investment at home did not diminish because industry constantly restructures and upgrades, investing in higher-skill, higher-technology product where it enjoys comparative advantages. The share of manufacturing investment in total Japanese FDI was higher in the 1970s (35 percent) than the 1980s (25 percent). Its relative decline leveled-off towards the end of the 1980s, and recovered strongly in the 1990s exceeding one third of total FDI in 1994. Despite this, in the first half of the 1980s, Japan continued to rely on exports as the source of global production even though it began to emerge as a leading international

investor. During that period, Japanese FDI was trade oriented in the sense that complementing rather than substituting domestic accumulation; its share in both world exports and FDI increased. The Japanese trading companies were instrumental in this process, handling a wide range of goods and helping the Japanese exporters to over come problems of entry and provided them with information on development in foreign markets.

Japanese producers did have to cede a certain share of the North American and the Japanese markets to increasingly competitive East Asian producers able to combine relatively cheap labor with relatively high technology in clothing, appliances, and consumer electronics. This was especially because the East Asian currencies were for the most part pegged to the dollar in the decade rafter the Plaza Accord and followed the dollar as it fell sharply downward against the yen, vastly improving the East Asian competitiveness. While the Japanese share of imports into the U.S. thus fell from 22.2 percent to 18.3 percent between 1986-91, the proportion held by the East Asian Four grew by the same amount, from about 11.75 percent to 15.3percent. In the same period, East Asian Exports to Japan grew perhaps three times faster than did those of the U.S..

Nevertheless, Japanese manufacturers were able to gain much more through stepping up their exports to East Asia than they lost as a result of East Asian incursions into their US and home markets. Japanese exporters moved into supply East Asian producers with the ever higher-tech capital goods needed to produce the labor- and capital-intensive consumer goods that they were exporting to US and to some extend, to Japan itself.

Between 1985-90 Japanese exports to East Asia in dollar terms thus grew by 148 percent, with the result that Japanese export to East Asia as percentage of total Japanese exports grew in these years from 18.7 percent to 28.9 percent. In particular, Japanese machinery exports to the Gang of Four economies quadrupled between 1985 and 1992, while those to the ASEAN-Four quintupled. Japan's dominance of the whole process of East Asian growth was manifested in its growing bilateral trade surpluses with all of the leading economies of the region. East Asia's industrial commercial dynamism thus turned out to provide a crucial enabling condition for the Japanese to improve the domestic production to counter the high yen. Because it costs so much in terms of the growth of capital stock to raise labor productivity outside of the manufacturing, the non-manufacturing sector had been no more able to raise its profitability above its 1970 level. Japanese producers could thus raise profitability by means of transferring

resources to over-subscribed manufacturing lines into many services lines only to the extend that, in the process, they could decrease wage growth even faster than they sustained reduced productivity growth with respect to both labor and capital inputs (JETRO, White Papers on FDI, 1997).

As have already been analyzed in chapter five, Japan has been successful in nurturing dynamic comparative advantages and climbing up the ladder of industrial upgrading under the Japanese-style infant industry strategies. It has been able to transform initially disadvantaged industries into competitive and advantaged onces. In the mean time, however, Japan also has many heavily regulated and protected industries, protected if not by outright tariffs and quotas, then by regulations and red-tape against imports. The upshots is that a new industrial dualism has emerged because as highly multinationalized efficient sector and a secluded import-averse sector survived side-by-side after the structural transformation during the early 1980s. The outward oriented sector is best represented by automobiles and electronics, while the secluded sector includes the sheltered "inefficient" service industries such as distribution, construction, finance, insurance, medical health, legal services, maintenance services as well as some inefficient manufacturing industries that are heavily domestic-market focused.

The worsening of recent dualism, however, in Japan's industrial structure, first, is related to repercussions of the collapse of the financial sector. The upheavals in the financial system are producing a severely deflationary impact on the real economy. Every year since the collapse of the speculative "bubble economy" at the beginning of the 1990s, the value of the country's assets has been contracting at a pace of over ¥100 trillion a year. What this means for an economy whose annual output is some ¥500 trillion will be clear if we think of it in terms of an ordinary household. It is as if a household with an annual income of ¥5 million were to be losing ¥1 million worth of assets every year. Under such circumstances the followings would result: firstly, people will not relax their purchasing behavior and therefore will not increase consumption or investment outlays. Instead, their response is to save even more so as to offset the depletion of their assets.

Secondly, it is because of the inefficient but still sheltered industries, which coexisted with the newly emerging high-technology, high-value-added, and knowledge-intensive industries. These sheltered and non-export industries has been characterized by low-labor productivity, low-efficiency and thus high-cost structure (Ozawa, 1996).

Closely connected with this phenomenon is what Ozawa has called "the price-industry-flow" syndrome. This syndrome reflects the futility of a neo-mercantilist industrial policy to build up manufacturing at home under protection and promotion; for the very competitiveness fostered at home drives up the value of home currency as well as domestic wages and makes home-based production less competitive, eventually forcing domestic firms to transplant production abroad. Ozawa describes Japan's handicaps with industrial polices in the process of catch up as follows:

> "The fundamental cause of the Japanese disease was stemming from the fact that Japan was not picking new winners. It emulated the advanced west by following the path of industrialization already taken and shown to Japan by the later. Japan was given an industrial map, so to speak, it was clear to Japanese leaders what "new" industries to build and what it would take Japan to build them. For instance, Japanese industrialists knew that the automobile industry would be an important future industry, as would be television and computer industries. Japan first pursued its comparative advantage in labor intensive, low-value-added industries such as textiles, toys, and sundries by exploiting an "natural assets-the low-skilled labor Japan had in relative abundance in the immediate post-war period. But it soon developed new advantages in more capital intensive, scale-based heavy chemical industries such as steel, ships, and synthetic fibers, by capitalizing on mobilized savings and the "create assets" mostly imported from the advanced west. From there, Japan moved on to the next stage of building an advantage in automobiles and electronic goods by introducing and innovation in organization of production popularly known as "lean" or "flexible" production. It is currently in the stage of increasing its output of technology intensive goods. Thus, Japan has moved up form low-tech, low-productivity sectors to high-tech, high-productivity sectors, step by step as Japan's capacity to do so developed in terms of assets availability and technological sophistication" (Ozawa, 1996,487).

As it is shown in chapter five, the institutional and organizational response of Japan to the progresses of the 1970s was that government issued a vision for reorienting the economy from labor-intensive and heavy capital-required industries toward high-value added and high-technology lines. In that context, incentives were provided to bias investment in that direction. Among these incentives factors such as granting low-interest loans, tax-breaks, organization of research and development consortia among the private companies to cooperate to carry out research and development, and a significant degree of protection for the new industries. Among these measures, the most important one is the organization of the government sponsored recession/depression cartels in order to protect the old or the classical labor and energy-intensive industries, such as the aluminum refining, ship building, and petrochemicals. By this way, is was

aimed also to allow firms in these industries to keep up their profits by artificially maintaining prices high , while they reduced their productive capacity.

8.3- Reforms Bounded by Corporate Capitalism

The first point to be noted for this emerging industrial structure as described above is that, Japanese showed the first sign of their incapacity to realize the changing nature of the surrounding environment and lack of mental flexibility to adapt easily. Japan's successful corporate practices under the bureaucratic supervision had been viable in a radically different environment, as described before in chapter six. For the same industrial structure to be acceptable, the role of *keiretsu* in establishing networks of exclusive dealerships in order to establish strict control over the firms, discriminate against the "outsiders", and to achieve a stable price structure must be guaranteed. In the past, as a result of exclusive keiretsu sales arrangements, Japan's auto-makers, for instance, have been able to maintain relatively stable prices and profitable market conditions at home, which until recently has been enhanced by Japan steady macroeconomic growth. The same situation applies equally to the consumer electrical goods industries. Thus, the keiretsu groups straddle both inward and outward sectors and the outward-oriented portion of business activities often benefit from the inward oriented portion. That is, the keiretsu structure segregated the Japanese market from rest of the world, and therefore pricing-to-the-market behavior has become possible, and the Japanese manufacturer tend to exercise this power. This may explain, at least partly, why price dualistic structure occurred between home and abroad.

Table-8.1 The U.S. - Japan product price comparison

Product	Lower/Japan	Lower/United States	Total	% Lower In the U.S.
Capital goods	7	15	22	68.18
Food	1	22	23	95.65
Miscellaneous	5	19	24	79.17
Auto parts	2	9	11	81.82
Autos	2	5	7	71.43
Electronics	21	14	35	40.00
Total	38	84	122	68.85

Source: Joint Survey of U.S. Department of Commerce and MITI, 1989.

The distribution system, among others, has been shown as guilty for causing the price differential between Japan and abroad. This price discrimination is a "hidden" form of creating subsidies that is, let domestic consumer indirectly subsidize exports and domestic production. The outward oriented/inward oriented dual structure provides a mechanism that allows such subsidization. As can be observed from table-8.1 above, there is huge discrepancy between product prices in Japan and the U.S.. According to the Joint Survey of U.S. Department of Commerce and MITI in 1989, of the Japanese products in the same category, 21 out of 50 were cheaper in the U.S. than in Japan. In contrast, only four of 35 U.S. products studied were cheaper in Japan than in the U.S. (Lawrence, 1991, 29).

Increased wages during 1980s extravagated the gap between export and non-export part of manufacturing industry increased. This suggests that industrial policy of Japan has turned out to be a destabilizing factor in the sense that it drives out scarce factors of production from competitive and efficient industries to the non-competitive inefficient industries. Much more worse, as the surveys of several private research organizations and ministries have recently highlighted, Japan's domestic markets were increasingly losing their relevance for the reasons such as, services are produced inefficiently by the small firms, many service prices are publicly regulated, market for services are imperfectly competitive, restrictions on the free entry into the regulated industries, and therefore high cost structure (JETRO, White Papers on International Trade and Industry, 1997).

High-cost structure, as shown in table 8.2, of the Japanese economy has been shown as responsible for this deteriorated structure because around 30 per cent of all the costs in the Japanese economy is constituted only by energy, transport, distribution and telecommunication sectors (Ito and Maruyama, 1991).

Table-8.2 Comparative productivity measures, 1987

Industry	Japan (100)	the U.S.	Germany	France
Manufacturing	100	112	84	87
Agriculture, Forestry, and Fishery	100	337	135	226
Construction	100	118	135	226
Wholesale and retail	100	167	137	171
Transportation and communication	100	155	128	131
Finance, insurance, and real estate	100	119	98	127
Overall	100	134	124	131

Source: Japan Productivity Center, International Comparison of Productivity Level and Trends, 1989.

In retail trade where more than one-fifth of overall employment takes place, Japan's labor productivity is around 44 per cent of the U.S. labor productivity. The same comparison in telecommunications is 77 percent. In each non-tradable sector, goods and services are 65 percent more expensive than tradable when Japan is compared with the United States. For instance, prices are higher by 60 percent in steel, 70 percent in cement, and 64 percent in petrochemicals than world prices (Katz,1996). Several experts of Japan interpret this high-cost structure of Japan as the source of Japan's "hollowing out". For instance, one of the serious indicator of this hollowing out is that it is the first time, Japan's multinationals sold more through overseas affiliates than through exports from Japan in 1996 (JETRO White Paper on FDI, 1997).

8.3.1-Post-Plaza Accord and the Strong Yen Syndrome

Continuous appreciation of the yen after the Plaza Accord has been another important challenge. As a matter of fact, the yen has been strengthening ever since the 1970s. In December, 1971, after the Nixon Shock, the yen appreciated suddenly from 360 to 308 to the U.S. dollar. In October, 1978, it went up further to 178. With the Plaza Accord, the dollar collapsed and the yen took off subjecting the Japanese economy to unprecedented stress. Between 1985-88, the yen's value increased by 56 percent in trade weighted terms and 93 percent against the dollar. After this period, despite the rate has been fluctuating, yet the long-term trend has been one of dramatic appreciation. In December, 1987, the yen was up to 120 to the dollar; by June, 1994, it has risen to less than 100, an in April, 1995, it hit its postwar record high of 81. By the last quarter of 1999, however, the rate was 105.

The initial reaction of the Japanese producers to the over-valuation of yen in the post-Plaza Accord was to resort to what is known as "pricing to market", namely to reduce yen export prices and to take cuts in profit margins on exports. This practice among the Japanese exporters to lower (raise) profit margins whenever their competitiveness is declining (increasing) is reflected by the disparities in the amplitudes of various variations in relative unit labor costs and relative export prices. It has been noted that Japanese exporters absorbed as much as a half of the real appreciation of yen between 1985 and 1988. High profits earned during the appreciation of the dollar helped the Japanese producers to take large cuts in profits margins rather than lose market shares. They were also greatly helped by the terms of trade gains and declines in the

prices of imported inputs brought about by the appreciation of the yen. Following the investment boom Japanese exports picked up, with volume rising at about 4.5 percent per annum between 1988 and 1990. Moreover, the structure of exports underwent a significant shift, from labor to technology intensive products. Exports to the US decelerated while the share of Europe in Japanese exports rose significantly, the rise in exports to Pacific Rim Countries was significant, particularly in capital goods associated with the increase in FDI; in 1990 exports to these countries were double the level of 1985. There was also a surge in Japanese imports which rose by more than 80 percent between 1985-1990, partly stimulated by the expansion of aggregate domestic demand led by the investment boom. Much of these additional imports, particularly in labor intensive manufactures, came from Pacific Rim countries.

The strong yen has made Japanese production costs in many cases the highest in the world and forced many companies to move their production location. As a result of Japan's chronic trade surpluses, it became more and more difficult to pursue the old export-led growth strategy when the yen was no longer undervalued. At the same time, the size of the Japanese economy coupled with the growth of export industries in the rest of Asia meant that the exporting countries were now much larger in relation to the importers than in the past. The appreciation of the yen and relocation of production by Japanese firms from their home base to affiliate abroad made a major impact on the volume, composition, origin and destination of Japanese imports and exports as well as those of its main trading partners in the second half of the decade.

Despite this, the general picture in the second half of the decade marks a transition from trade reliance to investment reliance. During this period of complementarity between the Japanese FDI on the one hand, and exports and domestic investments on the other hand, started to break down. The 1990s mark a gradual transition to the third stage with FDI becoming the principle source of global production for Japan, substituting rather than complementing exports and domestic investment. In this era, three factors played an important role in the transition of Japan from relying on exports to FDI. They were continued protectionism, the appreciation the yen, and increased competition from a number of low-wage, efficient producers, particularly in Asia (Akyüz, 1996).

Beside the surge in FDI in this period, in order to cope with the rise in yen, the outward oriented sectors had to keep raising productivity to remain export competitive. As the sectors succeeded in this endeavor, however, it again faced another round of yen

appreciation because the inward looking protected sectors did not absorb imports sufficiently enough to relieve the upward pressure on the currency. In other words, the outward oriented sector came to be entrapped in a tread mill; a vicious circle for productivity improvements and a greater trade surplus, to a higher value yen, and to an even greater need for cost cutting (Brenner, 1998). As Brenner evaluates;

> "This suggests that, limit in their ability to respond to the pressures of the high yen and slower growing markets through stepped up investment in manufacturing, and restricted in their capacity to raise profitability through productivity increase outside manufacturing, Japanese producers sought to maintain their established, export oriented production system by further expanding it into the Asian markets, where relative costs, during the first half of the 1990s, were made even lower by devaluation of the local currencies against the yen of the same order of the magnitude as that of the dollar. At the core of this effort was a huge increase of FDI in Asia, centered on subsidiaries of Japanese multinationals, but also including many members of the vertical keiretsu in Japan, which relocated to Asia to join newly emerging production networks organized roughly on the old lines. In just the four years 1991-95, annual FDI in manufacturing by Japan grew by almost 50 percent, from 12.3 billion dollar to 18.9 billion dollar with almost all of the increase absorbed by Asia, where Japanese manufacturing annual FDI almost tripled, from 2.9 billion dollar to 8.1 billion dollar. Over the same period, therefore, the share of manufacturing output produced abroad by Japanese firms rose from 6.4 percent to over 10 percent, by Japanese multinational from 17 to 25 percent. The dramatic ascent of Japanese production in Asia brought continuing reorientation of trade in that direction. By 1995, the share of Japanese exports going to Asia had climbed sharply to 44 per cent up from 31.1 per cent in 1990 and just 18.7 per cent in 1985. Imports from Asia into Japan grew less rapidly; still, between 1982 and 1995, reverse imports from Japanese multinationals' foreign subsidiaries increased at over 40 percent per annum, and by 1995 accounted for 14 percent of total imports. They have done their best to make their expansion into Asia aid improved productivity at home by facilitating the overall Japanese manufacturing division of labor, and allowed the substitution of Asian based for Japanese based low-waged, low-technology production only to the extend that the later could be compensated by the expansion of Japanese based higher technology, higher-waged production, after an 11 percent fall from 27.8 percent to 24.6 percent between 1973-1979, Japanese manufacturing force as a proportion of total, in sharp contrast to that of the U.S. ceases to fall through 1991" (Brenner, 1998, 223).

By the start of the new century, the competitiveness of nations is not measured only in terms of market-share maximization of national corporations in foreign markets through the well-known Japanese style adversarial trading practices. International competitiveness will be measured more and more with the ratio of export to GNP made by the multinational corporations in a country. Measured from this perspective, Japan's

situation is not bright enough. Among OECD countries, Japan is the poorest country receiving foreign direct investment. For instance in 1994, the share of foreign affiliate enterprises in total incorporated enterprises in manufacturing industry in terms of total assets and sales was 4.8 and 6.9 per cent for Japan and 11.5 and 9.7 for U.S. respectively (Economic Survey of Japan, 1996-97, 212). This means that the presence of foreign investment in Japan still remained below that of America and most of the European Union countries. As a result of this imbalance, the ratio of foreigners' production to total production in the manufacturing industries of Japan, the U.S., and Germany in 1995 realized as 9.1, 23 and 26 per cent respectively (JETRO, White papers on International Trade, 1997, 25). What is explicit here is the necessity for Japan to attract FDI to the country in order not only to reduce its current account surplus, reduce pressure over its over-valued yen, and to solve her trading problems but also to increase competitive infrastructure of the economy in the longer term.

Agglomerations of industry are changing dynamically under the interplay of a set of factors such as the location's capability to promote agglomerations, the negative effects associated with agglomerations (i.e., high cost structure) and transportation cost. After radical progresses in the information and telecommunications industry, the cost of transferring information and transportation is reduced. This, coupled with the pick up in direct investment, is greatly effecting the geographical distribution of industry worldwide. This means that economic development at one place stimulates growth in peripheral regions. Taking account of the negative effect associated with agglomerations, the resulting high-cost structure is causing industry to relocate its production facilities overseas. This factor also explains the Japanese enigma of industrial hallowing out. As mentioned earlier, the overseas production ratio of Japanese manufacturing industry continues to rise, and this has an effect on Japan's trade structure.

Contrary to initial observations of foreigners and the propaganda of the Japanese officials, barriers to direct investment in Japan as felt by foreign affiliates in Japan were high business cost, Japanese business practices, strict user demands, difficulty in securing man power, rather than language, strange culture of Japan, and lack of market information (JETRO, White Paper on FDI, 1997). For instance at the end of 1980, 1985, 1990 and 1995, Japan's external investment was 6.0, 9.3, 20.5, and 14.9 times larger than its internal investment, respectively, showing that the gap widened in the 1980's (Economic Survey of Japan, 1996-1997, 124).

Total factor productivity (TFP) is also an other crucial determinant of long-term growth. Table 8.3 shows that on the basis of human resources, research and development (R&D), infrastructure, and the economic system as determinants of TFP, according to 1991-1993 measures, Japan lies behind the USA and Germany when total industry is considered. Specifically in energy, wholesale and retail, transport and communication, finance and real estate, and finally in social and personal services Japan lies behind the USA. In terms of longer- term measures, it is clear that Japan's TFP is in the process of drastic decline. That is, rather than conjectural factors, some structural factors should be looked for behind this productivity crisis.

Table-8.3 Productivity in the business sector

	Total Factor Productivity			Labor productivity			Capital productivity		
	1960-73	73-79	79-97	1960-73	73-79	79-97	1960-73	73-79	79-97
The U.S.	1.9	0.1	0.6	2.6	0.3	0.9	0.4	-0.5	0.0
Japan	5.6	1.1	1.2	8.4	2.8	2.3	-2.3	-3.6	-2.0
Germany	2.6	1.8	0.6	4.5	3.1	1.2	-1.4	-1.0	-0.7

Source: OECD, Economic Outlook, 1999, 284.

Japan's declining productivity and TFP to a large extent is stemming from services. Having failed to liberalize services, industrial policy resulted in severe harm to the economy. Especially services such as telecommunications and transports are vital for the efficient functioning for the rest of the economy. Furthermore, protecting service industries can undo the benefits of liberalizing goods trade. For instance, cutting tariffs will expose manufacturing industries to foreign competition, but if poor roads, railways and other communications stop goods from getting to market quickly, those manufactures will be hobbled.

8.3.2- Post-Bubble Processes: Hollowing Out Deepens

The deep recession that began at the end of 1991 and extended into the second half of the 1995 was, in part, a reaction to the bubble itself. After engaging for almost half a decade in the most massive accumulation of capital stock, inventories, and labor without succeeding in raising their rate of profits, Japanese corporations could not but, sooner or later, cut back compensations on the growth of new plant and equipment inventories, employment, and wages. Moreover, pressed on both the domestic and

international front, Japanese manufacturers faced their greatest crisis: Due to the over investment of the previous years, and the resulting over-accumulation of productive capacity and of labor which was hard to lay off as well as the firms deep indebtedness, and banks' difficulties in lending, domestic demand stagnated, it was therefore impossible to once again ratchet up capital accumulation so as to raise productivity growth sufficiently to compensate for the rise of the yen.

Between 1991- 95, investment as a proportion of GDP fell from 20 percent to 14 percent and the average annual increase of capital stock fell by more than 1/3, compared to that for 1985-91. These reduced figures were still higher than the comparable one's for the U.S. in the same period, but they were entirely inadequate to the formidable task of maintaining competitiveness or profitability. By 1995, manufacturers had managed to raise the technological level of their exports still another notch. They had increased the share in total exports of high technology intensive products to 80 percent, from just 55 percent in 1985, while cutting back the share of capital intensive but medium technology products, such as steel, automobiles, and home electronics.

Nevertheless, in contrast to the years 1985-91, when, by virtue of their increased productiveness, and ability to control costs, they had come close to maintaining their international competitive position despite the dramatic rise of the yen, during the years 1990-95, they were unable to prevent relative units labor cost, which grew at the extra ordinary annual average rate of 11 percent, from rising even faster than the effective exchange rate profoundly reducing Japanese export competitiveness.

The results of this trend were extremely marked, including increases in overseas production, declines in domestic production, especially in manufacturing and reduction in Japan's trade surplus. As of 1995, the rate of production outside the country was 10 percent for all manufacturing industries and 25.5 per cent among those companies that moved part of their production facilities overseas (JETRO, White Papers on International Trade, 1997). Compared with the U.S. and Germany, Japan's rate of overseas production is still not very high. For Germany the rate is 21.3 per cent , in the U.S., the rate is even higher at 25.5 per cent. However, the impact in the form of the hollowing out of industries has been quite serious. This can be observed from foreign trade movements in table 8.4 and 8.5 in terms of exports and imports to various regions. By moving production facilities overseas, many corporations detached their production lines from their R&D facilities and activities.

Table-8.4 Exports by Region (1991-1998) (million yen)

	Total Export	Asia	Europe	N. America	S. America	Africa	Oceania
1991	42,359,893	15,679,811	9,719,724	14,481,386	540,733	812,764	1,125,455
1992	43,012,281	16,604,209	9,404,477	14,368,975	654,102	857,751	1,122,767
1993	40,202,449	16,412,063	7,544,846	13,691,466	632,972	831,796	1,089,246
1994	40,497,553	17,170,506	6,932,115	13,950,405	613,787	715,951	1,114,748
1995	41,530,895	18,910,714	7,214,247	13,107,292	616,320	703,761	978,545
1996	44,731,311	20,755,620	7,565,449	14,081,238	603,899	637,980	1,087,075
1997	50,937,992	22,654,474	8,905,063	16,554,553	909,546	667,336	1,247,004
1998	50,645,004	19,202,165	10,373,602	18,069,843	959,735	765,964	1,273,452

Source: Kanzei Nempo (Annual Report of Customs and Tariff) Customs and Tariff Bureau, Ministry of Finance (June, 30,1999)

Table-8.5 Imports by Region (1991-1998) (million yen)

	Total Import	Asia	Europe	. America	S. America	Africa	Oceania
1991	31,900,154	13,887,948	5,813,769	8,628,385	945,624	521,312	2,102,791
1992	29,527,419	13,266,421	5,187,554	7,893,962	820,535	461,644	1,896,980
1993	26,826,357	12,218,415	4,478,824	7,305,650	704,929	434,708	1,683,469
1994	28,104,327	12,785,968	4,821,427	7,586,883	739,321	424,257	1,745,985
1995	31,548,754	14,550,707	5,607,745	8,343,690	868,866	441,773	1,735,776
1996	37,993,421	18,075,036	6,423,690	10,060,954	933,716	550,570	1,949,027
1997	40,956,183	19,817,538	6,632,870	10,653,725	1,081,936	592,588	2,177,304
1998	36,653,647	16,941,906	6,143,348	10,053,711	943,832	512,868	2,057,832

Source: Kanzei Nempo (Annual Report of Customs and Tariff) Customs and Tariff Bureau, Ministry of Finance (June, 30,1999)

As of the third quarter of 1999, despite the on going reformation measures, Japan was still under the threat of double hollowing out, one regional and the other one national. Declines in the numbers of new and young business start-ups and increases in the number of new businesses closing down have been recorded. This phenomenon has been most evident in the manufacturing sector. For instance, some 7,000 companies went bust in the first half of 1999 with a total of 9.17 trillion yen ($75.79 billion) in debts, according to Teikoku Databank, because total debts surged 23 per cent to the highest level for any half-year in the postwar period (NIKEI, October 9,1999). Although the government launched in October last year a spirited campaign to counteract the credit crunch, creating a 20 trillion yen plan to supply loan guarantees to cash-strapped smaller businesses through the more than 50 regional credit guarantee associations nationwide, still bankruptcies remain a serious threat to an enfeebled.

To make matters worse, the effects of government measures to prop up weak companies are beginning to fade. Credit lines at governmental financial institutions are

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DOKÜMANTASYON MERKEZİ

almost depleted, and, moreover, commercial banks are still tightening their lending standards for smaller businesses despite the massive infusion of public funds into big lenders under a government-crafted re-capitalization plan. As the Financial Supervisory Agency has adopted stricter criteria for classifying problem loans, banks are now calling in loans to smaller companies with a vengeance, forcing many, even some healthy ones experiencing cash-flow problems, to file for bankruptcy. The number of failures has started rising again after several months of decline. It was reported recently that with the corporate heavyweights stepping up their restructuring efforts, the amount of debts left behind by bankrupt companies could come close to 20 trillion yen this year, easily eclipsing the record 14 trillion yen posted just last year (NIKKEI, October 9, 1999).

Entrepreneurial spirit has withered away to an extreme degree. The rate of new business launchings has been running at under 4 percent--less than the rate at which businesses are closing or withdrawing from operations. So the number of enterprises is declining. In the United States, by contrast, the rate of launchings is close to 14 per cent, four times the Japanese level. And since the business closure rate is under 12 per cent, the number of companies in operation is rising.

This Japan-U.S. gap in entrepreneurial spirit is a manifestation of the gap between the two countries' economies. The figures for saving show a similar gap, but in the opposite direction. The U.S. saving rate is under 4 per cent, while Japan's is in the 14 per cent-15 per cent range. Ordinarily a higher saving rate should be conducive to a higher level of investment, but the actual results are quite the contrary. There has been a decline in the number of factories throughout Japan but particularly located far away from Tokyo or Osaka areas in the last few years, which means that there is serious sign of regional hallowing out also. This contributed to recession in the major industrial centers as well as in the outlying regions of Japan. Today most of the factories in Japan operate at far below their capacity. The opening rate of new factories is only one third that of the U.S.. Moreover, the number of new businesses closing down exceeds the number of new businesses opening up. The second aspect of deterioration in the regional economies is closely related to the centrally- structured nature of the system. What has become striking is the direct connection between public works spending and the local mood. In other words, regional economies within Japan have become heavily dependent on the government's public works budget; very rare are the regions that have distinctive industries, start-ups, or unique features that allow them to prosper without

such public outlays. There is no local autonomy of the regional authorities in order to take necessary measures in order to escape the current crisis.

In terms of external hollowing out, the striking fact is that while the share of foreign production in manufacturing is about 10 percent, and lower than that of the United States (25.2 percent in 1993) and Germany (21.3 per cent in 1993), the actual number of investments in Japan by non-Japanese companies is very low (Kotabe, and Kent, 1996). The ratio of inbound investment over outbound investment is only 7 per cent. Compared with the world's other developed economies, this is extremely low, less than a tenth that of North America. United States' same ratio is 82 per cent. In Europe, the rate for the U.K. is 77 per cent, 78 per cent for France and 41 per cent for Germany (JETRO, White Paper on FDI, 1995).

The second result of this dualism is Japan's low level of import and export. In order to show this, several tables were prepared from different view points.

Table-8.6 Shares in world export and imports (%, values for total goods)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Exports										
The U.S.	11.5	12.1	11.9	12.2	12.0	11.5	11.6	12.4	12.5	12.2
Japan	8.4	9.0	9.1	9.7	9.4	8.7	7.8	7.6	7.4	7.4
Germany	12.0	11.5	11.6	10.3	10.2	10.5	10.0	9.6	10.0	10.0
Imports										
The U.S.	14.7	14.1	14.5	15.9	16.1	15.1	15.4	16.2	16.7	16.7
Japan	6.1	6.1	5.6	5.9	5.9	6.1	6.0	5.6	4.9	4.8
Germany	9.5	10.2	10.1	8.6	8.4	8.6	8.0	7.5	7.6	7.6

Source: OECD, Economic Outlook, 1998, Annex, 271.

The declining share of Japan in world trade figures is given in table 8.6, and its declining contribution to the world trade is given in table 8.7. The ratio of Japan's import to its GDP in 1996 was smaller than the same ratio in 1956. The worst is that in the recent years, as can be observed from table 8.8 and 8.9, the lion's share of the growth in manufactured imports has come, not from competing firms, but from the overseas affiliates of Japanese firms, particularly in Asian countries. In the other way around, according to one recent calculation, 2/3 of the entire growth in manufactured import over the past 15 years was from Japanese subsidiaries overseas.

Table-8.7 Contribution to Increases in world Trade

	Exports			Imports		
	1996	1997	1998	1996	1997	1998
Annual % change	4.1	4.2	-1.8	4.8	4.0	-3.8
Industrialized countries	1.8	1.5	0.3	2.4	1.6	1.5
US	0.8	1.2	-0.1	1.0	1.4	0.8
Japan	-0.6	0.2	-0.6	0.3	-0.2	-1.0
Germany	0.0	-0.2	0.5	-0.1	-0.2	0.4
Developing countries	2.4	2.7	-2.1	2.4	2.4	-5.2
East Asia	0.7	1.2	-1.0	0.9	0.3	-2.0

Source: JETRO, White Paper on International Trade, 1999.

Table-8.8 State of reverse imports by sector (Unit %)

	Engaged in reverse imports	Not engaged in reverse imports	Unknown
Total	46.2	45.5	8.3
Manufacturing	49.1	42.4	8.5
General and industrial Machinery	32.4	58.1	9.5

Source: White Paper on International Trade, 1996, JETRO, 1997, 35.

This means that even after the overvaluation of the yen, only the location of the factory changed, but not the nationality of the product. According to Sato's calculations, the share of manufactured goods in total merchandise imports was 22.8 in 1980, 31.0 in 1985, 50.3 in 1990, and 59.1 per cent in 1996. This implies that trade has already become a preventive factor for the Japanese economy, rather than a strong and sustainable source of its overwhelming growth.

Net exports of goods and services- for the April-June quarter of 1998 increased 0.7 percent because of a sharp fall in imports: Exports fell 0.4 percent, whereas imports dropped 6.8 percent, the fifth consecutive quarter of declines. For this reason, the ratio of Japan's current account surplus to the GDP on a seasonably adjusted basis rose to 3.1 per cent from 2.9 per cent in the previous quarter, exceeding 3.0 per cent for the first time since 1994.

This means that Japan's exports are shrinking, not expanding, and imports are falling faster. For instance, although the average trade/GDP ratio in developed countries and Asian NICs increased from 43 per cent in 1955 to 68 per cent in 1990, the same

ratio for Japan has declined from 21 per cent in 1955 to 19 per cent in 1990 (Katz, 1996, 10).

Table-8.9 Imports of manufactured goods/total merchandise imports (%)

Country	Year	Percentage
Japan	1995	59.1
United States	1993	82.7
Canada	1994	87.4
France	1991	79.1
Germany	1992	77.9
Italy	1991	72.5
United Kingdom	1994	82.0

Source: JETRO, NIPPON, 1996, 71.

8.4- Institutional Symbiosis versus Institutional Corruption

We have discussed before that, the "economy" is a network of multifarious and differentiated relations between particular classes of principals and agents: managers and employees, owners and managers, investors and entrepreneurs, but also citizens, politicians and bureaucrats. As we have concluded before in chapter three, performance of firms, governments, and economy as a whole depends on the design of institutions that regulate those relations. What matters is whether employees have incentives to maximize effort, whether managers have incentives to maximize profits, entrepreneurs have incentives to take only good risks, whether politicians have incentives to promote public welfare, whether bureaucrats have incentives to implement goals set by politicians.

Olson (1982) has shown that institutions organize all these relations. Institutional efficiency, in that sense, is also measured according to their capacity to contribute to those problems that are purely economic such as between employers and employees, owners and managers, or investors and entrepreneurs, those that are purely political, such as between citizens and governments or politicians and bureaucrats, as well as those that structure state "intervention" those between governments and private economic agents. Unless all these principal-agent relations are structured appropriately, necessarily we will face the problem of corruption.

As we have seen, corruption results from the conflict of interests within the state apparatus, which was defined as the clash between the interests of private officials and

the public, where usually a financial benefit is knowingly obtained at the expense of the public interest. In other words, corruption is the "misuse of public power for private profit". Corruption lies at one extreme of that spectrum of conflict of interest. When some markets are missing and when particular individuals, that is agents, have access to different information which principals do not directly observe (i.e., asymmetric information), then necessarily conflict of interest emerges. In such a situation, agents know their motivations, they have also privileged knowledge of their capacities, and they have chances to observe what principals cannot. They also undertake some actions that are, at least partly, hidden from the principal.

Since a pure market mechanism is not efficient to solve these problems, we have concluded in chapter three that institutional intervention would improve market performance, a duty to a large extent should be performed by the state. What is important here is that there is not a priori guarantee of a beneficial state intervention, at least to everybody. In that sense, from the view point of principle-agent perspective, the basic problem is to induce state to intervene in a good way, and induce agents to obey directions of the state in a way so as to maximize their own profits or satisfaction.

Within the paradigm of democratic representation, however, we should have to cope with the problems from the process of delegating the post of representation. Despite the fact that the state has a unique position because the state sets the incentive structures among private agents by exercising the legally qualified or legitimate coercive power, many of the functions of state are delegated by the elected representatives to someone else, specifically to the public bureaucracy. The delegation is inevitable because in a complicated society desired outcomes can be achieved only by delegating authority to related experts.

The delegation, however, raises the standard principal-agent problems. As it was underlined before, since the specification of all the future relationships among actors is not feasible under contingencies, executive and administrative agencies are left with a significant degree of discretion. But the objectives of bureaucrats need not be the same as those of citizens or of the elected politicians who represent them. Bureaucrats may want to maximize their autonomy or the security of their employment, render clientilistic favors to friends and allies, shirk in office, aggrandize their budgets or simply get rich. Again, they have private information concerning the benefits and the costs of their actions and they undertake actions that cannot be observed directly but

only inferred from outcomes or monitored at a cost. Hence, the delegation must inevitably give rise to agency costs.

Hence, the central institutional issue of state reform is how to enable governments to make good commitments while preventing them from making bad ones. Even if commitments were to be good policies, it is not easy to make them credible. The very capacity of the state to intervene makes it an attractive target for influence by- private interests and the very ability to commit opens the possibility of collusion. Hence, there are reasons to expect that the quality of state intervention in the economy depends on the internal organization of the state- in particular, on the relations between politicians and bureaucrats-and on the design of the democratic institutions that determine whether citizens can control politicians.

In a nutshell, what is argued here is that government intervention can be effective if the regulatory institutions are well designed and politicians can better control bureaucrats if they solicit the cooperation of citizens. But the question that still remains open is whether politicians will want to intervene well and to control the bureaucracy.

In order to highlight recent arguments for bad commitments, policies for the construction industry would be best alternative for any micro level analysis. By doing this, counters of Japan's political economy might also be seen. One of the recent studies on this subject has been accomplished by Woodall (1996). In its size and in its inter relationships with Japan's political institutions and political behavior, the construction industry is certainly a mantra. Japan's construction industry is the largest in the world, and construction investment as a percentage of GDP is the highest amongst advanced industrial economies. The construction industry is two-tiered at the top are a small number of very large general constructors (*Sanken*). At the bottom are more than 500,000 small firms. In the construction industry, the fundamental interests of three sets of powerful domestic political actors play key role: construction constructors, public works bureaucrats, and career politicians. The nature of the threat was not simply to the pursuit of various private and public interests, but rather to the structures which managed integration of private and public interest represented by the relationship between construction money, political careers, and the political consequences of political voting system. Japan's dual political economy in which "segmented policy markets" generates separate but interactive policy regimes that operate under different equilibrium conditions. This facade of the system can also be defined as "the

clientalistic state" as well as "developmentalist state". In the construction industry, both of these elements can be observed.

Political clientalism is an interaction characterized by the selective allocation of distributive policy benefits by public sector élites in exchange for the promise of solidarity and mutually beneficial inputs from favored private sector interests. His exchange may involve government subsidies, official price supports and import quotas, target tax-breaks, regulatory favor in the allocation of trucking routes, and other policy benefits. Three generic by-products, accompanied systematized political clientalism: Particularizm, political corruption, and economic inefficiency.

In analyzing the sources of these problems, Woodall suggests to consider three broad issues; the organization of Japanese politics, and its relationships to the construction industry, the nature of collusive action with in the construction industry, and the role of international pressure as a source of change and reform.

Despite the high cost of running for office and the low level of grass roots supports, the LDP managed to maintain its hegemony because its candidates were able to pull together the personal support networks. A pillar of most of these networks was the construction industry, the employer of nearly one tenth of the country's work force and massive reservoir of campaign contribution. It was the construction industry in other words, along with the farmers, and self-employed shop keepers, that forged ties between candidates and contributors. It was competition for construction industry support that fuelled the intra-party rivalries and it was loyalty to the construction industry that guaranteed LDP opposition to any efforts to modify the public works procurement process.

This means, for Woodall, "paying more attention to issues of incumbency security: constituency service, credit claiming, and distributive pork" (p. 95). The central message here is that, it was not Japanese culture nor traditions that produced a politics of factions and tribes, but rather such institutions as political voting, representative processes, and the system of campaign financing.

Parallel to the analysis here, the bidding process is the arena within which collusion and favoritism operate. For the most part, publicly funded construction projects do not involve open bidding but rather designated competitive tendering, i.e., bidding among a pre-identified list of qualified bidders. Collusion among these bidders and between the bidders and those responsible for designing public construction process is a key dynamic. A highly structured system of industry associations at both the

national and local level and the government procurement system lies at the hearth of the problem. Construction constructors reap inflated profits, government officials glean administrative powers and post-retirement security, and legislators harvest political contributions and campaign supports. The losers, of course, are the tax payers: By various estimates, bid-rigging and political payoffs inflate the cots of political construction in Japan by 30 to 50 per cent. And inflated bids have been estimated to produce between 16 and 33 per cent of the construction industry's total revenues.

8.4.1-Further Remarks on the Lack of Accountability in the System

For a long time, Japan's political leaders have reigned while bureaucrats have governed. And the bureaucrats have not governed according to clear, transparent rules, but have used the discretionary power afforded them by the lack of such rules to exercise power through guidance and special relationships. Indeed, special relationships, often of a semi-feudal nature, in both the public and private sphere are the basis of much of Japan's economy. Because such relationships are ultimately based on power rather than law, they are subject to abuse and corruption. Closely related is the nature careers in Japan's bureaucracy. This problem is exacerbated in Japan by the close intertwining of the bureaucracy and business, and particularly by the practice of "amakudari," or "descent from heaven," in which retiring government officials land highly paid jobs in private businesses. The majority of government bureaucrats retire between the ages of 50 and 55, so they must "descent from heaven" into second careers in the private sector, quasi-governmental entities, and elective politics. Consequently, they build bridges of mutual benefits to legislators who influence passage of budget proposals , in greasing promotional wheels and in securing attractive amakudari landing spots. In return bureaucrats assist via preferential allocation of public works contracts, advance information to support claiming, and informal campaign support.

Any change in the status quo threatened to undermine the reemployment system, which is essentially an informal extension of the careers ladder for Japan's government officials. But the crisis also created problems for elected politicians many of whom believed their cares depended on claiming credit for the preferential allocation of structural policy benefits. Woodall concludes that "bound by ties of mutual self interest legislators, government officials, and constructors were willing to endure great hardship

to protect the corrupt bidding system" (p.80). This all operated in an environment of political clientalism.

Although Japan's difficulties are manifested most strongly in economic terms, the main problem is the absence of a true rule of law and of government accountability. In the process of compensation of the "losers", the ideal of keeping them in the race, and creating national champions over foreign markets via several pragmatism of state guidance, an excessive bureaucratic involvement to the system has become unavoidable. That is why it has been commonly accepted that one of the "excesses" of the current Japanese enigma is stemming from bureaucratic entrenchment and/or excess government involvement, which lead to serious institutional collusion and corruption. As we have discussed in chapter three on the institutional nature of collusion and corruption, "stable societies tend to accumulate more collusion and organizations for collective action over time. Interest seeking organizations and collusion reduce efficiency and then aggregate income as a result of which political life tends to be divisive and finally social crisis come soon after"(Olson, 1982, 37-74).

One additional element which aggravated the extent of bureaucratic entrenchment is the underdeveloped representative process and the elimination of the opposition. This aspect of the system is defined by Noguchi as the following:

> "Ironically, in Japan it was the bureaucracy, not a political party or movement, that promoted social democratic policies... The same can be said for the later period of rapid economic growth. The role that the government played was not to promote the development of the leading industries but to create conditions allowing the smooth departure of industries in decline and to provide protection and aid for lagging industrial sectors and regions. It is thus difficult, at least in terms of policy content, to distinguish between social democracy and bureaucratizm in Japan's case...The result was that the opposition was unable to come up with a policy agenda of its own distinct from that of the government. Its policy ideals were reduced to abstractions, and it was forced to rely on a doctrinaire issues...If this state of affairs continues, policy will come to be made entirely at the bureaucrats' pace rather than through the political process...And now that there is no longer a real political opposition, the civil servants' hold has become even stronger" (Noguchi, 1997, 82).

Without doubt, there are several "officially" progressed sophisticated explanations for the existing bureaucratic dominance over the economy. But here the role of Ministry of Finance will be criticized for the emergence of recent systemic collapses in terms of corruption and system's social costs to the society.

8.4. 2-The Ministry of Finance (Ookurasho)

One of the latest and detailed analysis of the Japan's financial system and of the responsible ministry has been made by Hartcher (1998). He argues that Japan's Ministry of Finance (MOF) is much more than an office of government. It is a political, economic and intellectual force without parallel in the developed world. It enjoys a greater concentration of powers, formal and informal, than any comparable body in any other industrialized democracy. In Japan, there is no institution with more power. "The Ookurasho, high priest of modern nationalism, is not about to allow itself to be hypnotized by the imported heresy of a supreme market. Efficiency and perfect market outcomes do not respect the demands of nation building and nationalists...So Japan's stock market is forbidden to fall to its natural point of resistance, no matter how overvalued it may be, and its financial industries are exempted form the full play of the forces of gravity, no matter how heavy they happen to be. The giant life insurance companies are protected from the forces of competition, no matter how harsh or vast, and the banks are permitted to collude in setting rates, no matter how great the loss to ordinary bank depositors" (p. 50).

In the past, five central elements in this system of control were prevalent: control over interest rates to keep them artificially low, control over foreign exchange and capital flows, control of the banking system, the establishment of strategic financing institutions, such as the Japan Development Bank and the Export-Import Bank of Japan, and the doctrine of a balanced budget. The logic and impact of these institutional responses has been discussed before, mainly, in chapter five and six.

After analyzing the impact of its protective polices and excess regulation over the economy, MOF can also be accused of leading to the current crisis. First, through the budget MOF has subsidized many of the inefficiencies in the economy. Second, through its control of the chairmanship of the Fair Trade Commission it has tolerated many cartels and other anti-competitive practices in the corporate world. Third, through its control of corporate accounting rules it has set the benchmarks for corporate transparency and private-sector performance. And fourth, through its supervision of virtually all institutional investors, the banks, and the stock market, it has available to it all the mechanisms of corporate governance, those systems which direct company behavior. These institutional procurements underlines the role of MOF in the currently existing regulatory distortions.

Hartcher calculated that in the United States, for instance, an estimated 6.6percent of the economy is classified as falling into regulated sectors. In Japan, the comparable figure is 50.4 percent. And within Japan, the Ministry of Finance presides over one of the most heavily regulated industries: 100 percent of the many fields of the finance industry are regulated. This makes it even more closely supervised than the notoriously over-regulated agriculture sector, with its regulation ratio of 86 percent. For Harcher, "this helps explain why the Ookurasho has emerged as the chief advocate for the status quo, the point of resistance in the national drive for deregulation. By contrast, only 16.8 percent of the sectors in Japan's manufacturing industry are regulated. So it might not be surprising that the Ministry of International Trade and Industry has become, of all the government ministries, the most outspoken advocate for reform in Japan" (Hartcher, 1998, 195).

The first official survey of national regulation was carried out the year before the Maekawa Report (1986); it counted a total of 10,054 national regulations in force. In the most recent survey available, carried out in 1994, there were 10,945 regulations in force. In other words, a decade of supposed deregulation had actually increased the number of regulations by 891, or 8.9 percent. Of those ministries which had increased the net number of regulations, the most active was the Ministry of Welfare. Next came the Ministry of Finance. In the nine years from the first survey to the last, the Okurasho increased the number of its regulations in force by 275, or 25 percent (Hartcher, 1998, Noland, 1995).

The result is that, according to Sato calculations, in case of any "price destruction" or collapse of any monopolistic structure there has been a phenomenal reductions in domestic prices. For instance, "upon the recent deregulation measures, prices fell by 63 percent for tuna, 32 per cent for bee, 17 per cent for whisky, 25-30 per cent for gasoline, and 25-30 per cent for PCs 25-30. According to some calculations, if there were not import impediments, Japanese (retail) prices would fall by 41 percent" (Sato, 1996, 55).

In the same way, according to the economic survey of the Economic Planning Agency (EPA) for the season 1996-97, economic effects of deregulation on the major sectors of the economy is outstanding. For instance, the scope for improvements in productivity and cost reduction for telecommunication is 41 per cent and for banking

the same figure is 22 per cent. As a response to this productivity increase and cost reduction, demand for telecommunication and banking services would increase by 10 and 4 per cent respectively (EPA, Economic Survey of Japan, 1996-97, 215). According to the latest statistics on investments notified to MOF, in the first half of fiscal 1998, FDI outflow fell while inflow grew strongly, thus significantly reducing the imbalance between inflow and outflow. If the process continues, it can be expected that domestic prices declin and the quality of services would increase so as to stimulate domestic household consumption expenditure further.

One other result of this excess regulation over the economy can also be shown in case of Japan's status as the world creditor and donor country. There is a serious paradox; Japan is the main source of global credit, argues Hartcher, but not the main market for it. When companies and institutions, both Japanese and non-Japanese, borrow money from Japan's banks and institutions, they prefer to sidestep the Tokyo market and go outside Japan to the Euro-market. And they prefer it by a margin of 3 to 1, simply because of the high transaction costs associated to the excess regulatory process in Japan, which increase the cost and complexity of doing business there. All of Japan's capital markets were beset by the "hollowing out" that followed the bubble economy. An unavoidable result is that, Japan now is a victim of a dual hollowing out (Hartcher, 1998) . In the financial sector, as we have shown in chapter seven, net employment is actually declining as U.S. and European financial institutions abandon the Tokyo market in favor of Hong Kong and Singapore, but also Japan's famous "sacred treasures" of life-time employment and seniority wage system is also under serious threat (Michio, 1998).

Because of the excess regulations, moreover, Japan's financial and capital markets, compared to overseas markets, are not responding sufficiently to the financing and investment needs of the economy. Despite several emergency measures having been proclaimed, by the last quarter of 1999, consumption has been still stagnated, corporate collapses has increased dramatically, and the rate of unemployment has exceeded that of 5 per cent historical record level since the employment statistics has started in 1950s. (JETRO, White Paper on Economic Activity, 1999).

In such an environment, the most of the issues has lost its original meaning and policies have lost their functions. Ozawa argues that the problem is much deeper. Politics, for Ozawa, has been reduced to the task of appropriating the dividends of "the Japan, Inc.". The Cold War was over, but still Japan persisted with this system, "and

Japan therefore remains unlike 'normal nations'. As part of the revolution he prescribed, Ozawa wanted an overhaul of the economic system:

> "The bureaucracy had operated a "factory-management approach" of centralized control over industry and its financing. While this was fine for Japan's catch-up industrialization, it was now obsolete: The failings of management-style administration are clearly revealed in the travails of our financial administration, which recently attracted attention with the collapse of the bubble economy. Every aspect of the finance industry, from the building of new bank branches to the establishment of deposit interest rates, was carried out under the strict regulation and supervision of the Ookurasho... the ministry also gave detailed guidance on every action taken by individual financial organs. Again, we return to the image of the foreman managing his factory." (excerpted in Hartcher, 1998, 187)

In the routinized investigations of the Fair Trade Commission, it has been declared recurrently that there was no sign of serious anti-competitive practices in Japan. "This was not surprising" says, Hartcher, "because the chairman of the banks' cartel is the Ookurasho, and the co-chairman is the Fair Trade Commission. The banks were the winners and Japan's consumers the losers; an increase of one percentage point in the average deposit rate would have required the banks to put an extra 3.6 trillion yen ($36 billion) into their customers' accounts each year. And the deposit rates were about 2 percentage points below the rate on overnight call money at the time. The bank cartel survived deregulation intact. Indeed, two years later, they were more uniform than ever; of 149 banks of all types, 147 offered an identical rate on ordinary savings accounts of 0.1 percent.

The Ookurasho had compounded this with its other failings. These were many, but in the public mind the most serious were the banking crisis and its most upsetting element –the appropriation of public money to solve the Jusen problem. Perhaps the most blatant evidence of favoritism, however, was the agreement by the Finance Ministry to approve the Liberal Democratic Party's request to resume a full-scale expansion of the shinkansen (bullet-train system). For nearly thirty years shinkansen projects have been synonymous with the pork barrel in Japanese politics. Expansion of the system had been frozen for seven years because of Japan's crisis.

In short, it seems that the three guiding philosophical principles of Japan's "big-bang", namely free, fair, and global, has been shadowed because of the so-called "Japan residual". The effect of these principles would be revolutionary. They are the precise

opposite of the working principles that dominated the postwar financial system, which was controlled and operated for the benefit of "insiders".

8.4.4- Problem of Legitimacy in the System

As I have argued before in this chapter, the required consensus at the top of the system, which gave priority to production at the expense of other social factors, was successfully established between the bureaucrats, politicians, and the big business. This system was maintained because, it was propagated by the systemic coalition as the only route to the Japanese industrialization. It was also maintained that the cost of system has to be paid by the society as a whole, and at the later stages of industrialization, its costs will decline whereas its promises to the citizen will be materialized in concrete welfare measures throughout the society. Despite the system achieved remarkable success in terms of its high growth rate, employment, competitiveness, and also equitable distribution of income till the end of 1960s, there has been growing disparity between economic growth and social welfare since 1970s, and reached its peak at around the burst of the bubble economy. Japan's traditional propaganda for Japan's vulnerability to the external shocks and fragility in terms of lack of vital resources seems to have lost their power to stimulate individuals to adhere and to devote themselves on the basis of old incentive schemes (Hamada, 1998).

We have discussed before that the process of mind-setting in Japan dates back to the early Meiji era for the creation of a rich country with strong army, and this ideology was reproduced during the second world war era. The Okocho School was the pioneer of the intellectual wing for the creation of a so-called company person, whose motivations, unlike extreme self-interest oriented economic actor of the western type, based on long term collective utility. A game theory approach says that the necessary condition for collective utility maximization is the equality of the marginal rate of substitution among the participants, which in the final analysis depends on the player's relative power. It must, therefore, be expected that this iterative game will begin to collapse provided that participant realizes that payoffs are less advantageous and he evaluates his share as unfair to him. Here there are two subjective elements for the effective functioning of collective utility bargaining; one is relative ignorance (lack of awareness) of the nature of the game and perception (internalization) of the payoffs by the participants. In order to convince people that this game is faire and outcome is

equally distributed to each participant, actors such as consumers, employees, and small-producers was successfully pacified for a long time.

In this pacification the role of government's systematic propagation played a central role. As Garon has discussed, the widespread sense of crises and pessimism in Japan today occasioned a return to more visible efforts to manage society on the basis of the conventional tools. In his words, "just as state officials following the Oil Shock of 1973-1974 demonized the previous high-growth era as one of unrestrained mass consumption and shallow materialism, bureaucrats and the media currently thought the "collapse of the bubble economy" as a moral lesson for the Japanese people"(Garon, 1997, 232). The central message to the people is that only by returning to the habits of diligence, thrift, and conservation of resources the nation can not maintain its position in world markets and preserve social stability of post-war consensus around production.

Until now we have pointed out that domestic and external economic environment has already changed and thus a new kind of consensus at around a well-defined and inclusive public good should be established for an incentive scheme in order to strength Japanese economic system by the next century. In fact, the era of rapid growth in 1960 and the 70s and rapidly rising affluence was not to last forever. The bubble economy experience, which burst in 1989 and was replaced by the prolonged recession and continue throughout 1999, suggests that once effective institutions of catch up model had already lost their relevance and therefore new institutional change lies at the hearth of the long-run process of economic development. The distinguishing aspect of new institutions is that they should provide the missing link between development and growth, which I suppose one of the severe deficiencies of Japan's developmental model.

One of the main messages that we have derived from the institutional inquiry in chapter three was that economic development is "economic growth accompanied by "efficient" institutional change"(Nabli and Nugent, 1989, 1342). It is also well articulated that there is a mutual dependence, rather than one way relationship, between institutional change and growth. It should be noted, therefore, that because of the nature of Japan's developmental ideology, this link between the institutions of growth and the institutions of development has already been weak throughout post-war industrialization experience.

8.4. 5- Social Cost of the System

As any other system, Japanese system also entails a cost of maintenance. Bennett and Levine argues that "social cost refers to anything considered to be a loss borne by the third persons resulting from productive activities. Deprivations as the result of a production-first policy can be defined as "social costs". Since social costs are dependent on some one perceiving them, the concept implies a sense of value, of social goals"(Bennett and Levine, 1976, 447).

There is increasing evidence, however, the consensus over the post-war system has already weakened. This can be shown even in terms of explicit welfare terms. To begin with, the social cost of the system is being analyzed in terms of both absolute and relative deprivation. Considering the first one, it means deterioration of physical environment, reduction of income as a result of involuntary unemployment, increased congestion in living space, reduced opportunity for the pursuit of leisure, and increased commuting. Relative deprivation, on the other hand, takes place in case of failures in attaining minimum expectations or rewards, issues of equity and failures to gain steady advances in life styles or welfare. Among the indicators of relative or absolute deprivations, there are several evidences.

Among the absolute deprivations, diseconomies of scale has been one of the crucial problems. Excessive concentration of industry locations among three major cities of Tokyo, Osaka, and Nagoya lead to the several dramatic stories. Among the classical cases of environmental destruction, the Minamata mercury poisoning of early 1970s and the Tokai-mura radioactive leak, which caused local fallout of business and serious threat to the health of people living around this subsidiary of Sumitomo Metal Mining Co., in Ibaraki Prefecture in the late 1999 are among the most serious episodes of ever known (NIKKEI, October 18, 1999). Other than these, it is not difficult to mention several of damages to the water, atmosphere, and so forth. Although these kind of problems are not unique to Japan, the side of the problem which is closely related to the system's priorities on behalf of the system has a serious threat for the society. For the sake of production and with the fear of losing competitiveness and, therefore, market share, neither business enterprises took the necessary responsibilities nor did the government enact the required legal legislation to increase environmental standards or bureaucrats enforce the existing measures. In the case of the Minatama Mercury disease, for instance, although it was well-known that there was a serious gas leak to the

surrounding waters, until it caused hundreds of deaths and several hundreds of handicapped people around 1970s, MITI strictly objected any precautionary measures (Kunio, 1994, 177). Even in the case of the Tokai-mura radioactive leak, it has become evident that Japan still lacks the required legal preventive enforcement before accidents take place, and the compensation scheme after it occurs.

In terms of relative deprivations, however, the situation is getting even worse. As should be recalled, among the determinants of Japanese household's saving behavior, lack of confidence in the system and the precaution motive for post-insurance days takes precedence. This can be seen as a substitute to the insufficient welfare measures of the state. As Pyle noted because of this "underdeveloped welfare state, and unilateral emphasis on growth the population felt themselves to be extremely vulnerable, uncertain about their future, and also increased company dependence even further (Price, 1997, 222). This might be interpreted as the loss of trust and belief in the system's priorities, and moreover, welfare society and social justice has increasingly dominated economic growth as the primary goal.

Although per capita GDP in Japan is one of the highest among the develop countries, in terms of purchasing power, however, Japan lies behind. For instance wages for Per working hour in 1993 were 1,782 yen in Japan, 13.23 dollar in the U.S., and DM 32.04 in Germany. As calculated in terms of purchasing power parity (PPP), Japan lies behind all of them. Japan's wage for per working hour in manufacturing in terms of PPP is 1,782 yen in Japan, 2,633 yen in the U.S., and 3,057 yen in Germany (Asahi Shimbun, Japan Almanac, 1997, 102). Sato has calculated that, "non-tradable goods 65 percent more expensive than tradable goods when Japan is compared with the United States. This is because services are produced inefficiently by small firms; many service prices are publicly regulated; market for services is imperfectly competitive: and results of restrictive free entry into the regulated industries" (Sato, 1996, 50).

As we also discussed in chapter five, by the end of 1960s, the post-war developmental policies around fast growth produced the desired impact over the society, particularly in terms of equal distribution measures. The Japanese state was hesitant enough to declare Japan as a "model middle-income society". This "middle-income society" argument was still intact even around 1998. It was argued that more than 90 percent of the population perceived themselves as middle class (JETRO, 1997, 146).

This argument has, however, been severely criticized in terms of the method used in order to calculate income distribution and the way of its interpretation. Sato (1996) and Woronoff (1996) for instance, noted that the supposed evidence of equality comes from the use of the Gini Coefficient according to which income is rather equally distributed. In the measure of income inequality, however, the role of asset distribution by household was excluded. As we have discussed in the previous chapter, a decade of the bubble economy and the public policed which was proposed to solve bad loan problems and stimulate the economy to a sustainable growth truck mainly through the use of public funds has crucial distributive results in the society. Taxpayers are rumored to have to pay upwards to $500 billion to bail out the system. That is equal to 12 per cent of the whole GDP of Japan. That is greater than the whole giant construction industry that employs 10 per cent of the work force. Bureaucratic élites, on the other hand, have been arguing that Japan's big business is so big and important not for Japan, but also for the world economy that their fate can not be left to the ebb and flow of market mechanism, and should be saved through additional public initiatives.

We emphasize on the role asset, more specifically, because "assets are what determine wealth and heavily influence the reality of belonging to a specific class"(Woronoff, 1996, 197). Sato in his approach, emphasizes on distributional equity by considering the role of household sector within the private economy. Considering basic assets such as land, money, life insurance equities and dwelling that households control, Sato underlines that "none of these assets empower households to participate in corporate management because households own only two percent of industrial bonds and corporate equities. This means that large corporations are their own masters and their executives can run them as they wish with almost no intervention from outside (Sato, 1996, 92).

Table-8.10 illustrates that the overwhelming majority of the household savings are kept either in terms of deposits or time deposits at the banks. The second observation is that since Japan has been pursuing low interest rate policy in recent years in order to stimulate the productive activities of the firms and to induce domestic demand, it is clear that there is a continuous tendency of income transfer from the household sector (the creditors) to the corporate sector (the debtors).

Table-8.10 International comparison of the holding ratios of financial assets in household economies (%)

	Life insurance Pension funds	Cash and other deposits	Time and Saving deposits	Share	Bonds	Other
Japan (1995)	25.3	10.4	51.9	6.5	6	--
US (1994)	34.6	3.9	22.7	22.7	10.7	15.0
Germany (1994)	25.1	8.9	36.1	13.0	14.0	2.8

Source: EPA, Japan Economic Survey, 1996-1997, 68.

Table-8.11 shows that, in terms of households, returns from assets per household were not very significant, although they decreased markedly in the case of older people, who have relatively large returns on assets.

Table-8.11 Monthly income and returns on assets for households (units: 1,000 yen, %)

	1992	1993	1994	1995	1996
Working households income	563.9	570.5	567.2	570.8	579.5
	(2.7)	(1.29)	(-0.6)	(80.6)	(1.5)
Proportion of return on assets	2.5	1.4	1.2	0.9	0.8
	(56.0)	(-43.0)	(-20.2)	(-23.6)	(-12.5)
Non-working households income	245.2	240.1	241.6	248.0	255.4
	(7.3)	(-2.1)	(0.6)	(2.6)	(3.0)
Proportions of returns on assets	12.0	7.5	7.8	3.5	2.5
	(-16.3)	(-37.0)	(3.2)	(-54.9)	(-29.7)

Source: EPA, Japan Economic Survey, 1996-1997, 65.

Those who invested in land, stocks, and other assets made a fortune. Even worst in this picture is that although most sources of income were taxed away in Japan regardless of salary-man, factory worker, professional, and shopkeeper, or farmer, stock and land earnings either had been excluded until the burst of the bubble crisis, or when they were taxed, they were under reported by the corporations. In fact, there were "9:6:4 rule whereby wage earners whose taxes were withheld at the source paid taxes on 90 Per cent of their income, the self-employed only paid on 60 per cent, and farmers on 40 per cent" (Woronoff, 1996, 202). The geographical distribution of wealth is also getting worse. In 1980, for example, per capita income in Tokyo is 26 per cent higher than in the rest of Japan. By 1990, however, it almost 60 percent higher. The effect of tax structure which favors property holders and relies on fixed income also played a very important role on the income inequalities.

When all of these effects are combined together, it would be clear why people started complaining with the argument that it is not "of the people, by the people, and for the people", but "of the triad, by the triad, and for the triad". On the basis of these evidences, the Public Opinion Survey on the Life of the Nation has also underlined that, contrary to the developmental argument for "equal outcome to all, rather than equal opportunity" which was supposed to have materialized in equitable income distribution figures, around 74 percent of respondents felt that the system is unfair.

In conjunction with Japan's deteriorating trade performance, one of the clearest lessons of the post-bubble period is that domestic demand should be stimulated so as to complement foreign demand as the primary source of stable growth. In that sense, a sharp decline in consumers' will to spend is a serious handicap for the economy to be stimulated. This is probably a reflection of the Japanese people's loss of confidence in their country's future. This is related to the woes of the financial sector. Few expect the Japanese economy of the twenty-first century to recover its past vigor. And as long as large numbers of people are feeling insecure about the future, spending will not pick up, and the economy as a whole will not recover.

It has become evident that Japan's stimulus packages since the collapse of the bubble economy did not bring the desired motivations to the private investors, entrepreneurs and consumers over the country. That is why although Japan's consumer price index fell by 0.1 per cent year on year in July,1997, real GDP during the April-June quarter of 1988 shrank 0.8, or an annualized 3.3 per cent, mainly due to weak consumption, poor housing investment and a sharp decline in corporate business investment (NIKKEI Weekly, September, 14 1998). Both private and public real consumption expenditure is showing a steady decline generally since 1990, but particularly after 1995. Accordingly, real total domestic demand also shows a severe downward trend since 1990 (OECD, Economic Outlook, 1998, 232).

It has been argued that before one central feature of this lack of consumption is related to the classical Keynesian problem of excess savings according which, as an economy matures, and the need for investment slows, the labor share of income rises and so does personal consumption. In Japan investment fell, but consumption did not rise to replace it. Since neglected consumers can not be compensated under the current domestic and external constraints, they try to guarantee their future by substituting savings to the place of insufficient welfare precautions. As Calder concluded, "even by the late 1960s, the Japanese government's welfare expenditures were only one-half the

share of GNP of those in the United States, and one-third the levels in France and Germany" (Calder, 1989, 349). Because of this "underdeveloped welfare state, and unilateral emphasis on the growing population felt themselves extremely vulnerable, uncertain about their future, and also increased company dependence even further (Price, 1997, 222). This last statement underlines in an implicit way what to do in order to stimulate domestic demand, which should as the necessary condition of revitalizing the economy because it has already become evident that by the next century Japan's will has to be a domestic demand driven economy.

Other than the cited problems such as financial insecurities, unfair income distribution during and after the bubble economy, under-developed welfare arrangements, low-purchasing power capacity of consumers, mainly because of the high price structure of the domestic market, there are also several other failures of the system. Among these, briefly, labor suffers from "under-satisfactions" of lack of leisure, still longer working hours compared to major industrial countries, enforced job rotations and thus divided families; Concerning the female labor force, there are additional problems there. Strict discriminations against women in the business environment, in terms of low wages, sexual harassment, prevention from top level career opportunities, and so forth. Also, people suffer from not having their own houses along with a life mainly in large cities. Moreover, they still have to spend their life in very small houses (what Woronoff (1996) calls "rabbit hutches").

8.5 Why Change and Reform is So Difficult in Japan?

Ishizuka, a columnist for The Nikkei Weekly, asks the fatal question: "Why is it so difficult for Japan to change despite all the talk and slogans about the importance of reforms and changes?" (August, 13, 1998, 18). A plausible answer to this question is proposed by Yoshimura and Anderson (1997). They argue that "rather than pursue a clear goal or vision, Japanese organizations often myopically focus on what they view as the correct model, process, or attitude: keeping up with rivals or maintaining market share, for example. They excel at improving efficiency but usually only with incremental steps. Obsessed with avoiding embarrassment, managers often accept repeated failure rather than risk even considering a novel solution to a problem. The characteristics tendency is to wait and see, and then go with the group. To avoid blame and see face when things go wrong, managers present a facade of harmony...Indeed

with the weight of long established routine still controlling government and business, the Japanese economy continues to operate like an export Frankenstein-even though the logic of the rising producer state makes less and less sense. Yet politicians in Japan appear unwilling, or perhaps unable, to chart a new course. A system which continues as a culture of irresponsibility"(in Crawford, 1998, 181)

A second complementary explanation can be found in the ideal type of Japanese relational capitalism, which argues that Japanese capitalism is difficult to understand in terms of power structures, as a system without a clear leadership (Calder, 1988). Understanding of this power structure, upon which a national capitalism has been established in Japan, has crucial importance because the primary source and motivation for change in capitalistic development process is closely related to the search for efficiency and conflictual interest among the power-holding groups and/or individuals. Changes in capitalism are certainly driven by more or less external forces such as political integration, technological developments, international alliances, mobility of financial capital, and the like (Soros, 1997).

Unlike this, in Japan both in politics and business, leadership is shared and decision making diffused. Labor is controlled in the interest of the firm, firms, in turn, are controlled in the interest of the industry, and industries are controlled in the interest of "the Japan Inc.". Because of the many checks and balances in the Japanese society, changes take place slowly, and conflicts are settled in such a way that no one interest group overrules the others. That is, capitalism is change, but the dynamics differ from the Anglo-Saxon variety to the Japanese kind (Adams, 1994).

In this model of "checks and balances" the position of bureaucracy, which constitutes the third element in my study, should be modified further, because the reason for Japan's policy inaction has close interrelationships to the bureaucratic entrenchment or excess government involvement, which has distributive implications for different groups such as firms, industries, employees, consumers. Since public action lobbies affected by regulation, naturally have incentives to seek regulation that benefit them and resist one that hurts them. This kind of regulation is endogenous to the system so that it is supplied in response to the demand by the groups potentially affected by it. We can expect that any kind of structural and institutional change away from this kind of regulation and distributive mechanism will be resisted by beneficiaries of the existing system.

Yamamura's point is illuminating at this point. The advocates of 'unique Japan' and thus "non-convergence" hypothesis offer that "...Japan has deeply embedded institutional symbiosis". What has become so obvious by now that it has turned out into an "institutional collusion". Institutional symbiosis refers to the close and cooperative relationships maintained with the aid of formal and informal institutions by political and economic actors to realize gains for both the actors involved and for society. Institutional collusion, on the other hand, is institutional symbiosis that benefits only the parties involved while imposing costs on society, that is, a rent-seeking activity engaged in with the aid of formal and informal institutions."(Yamamura, 1997, 297).

This situation, clearly, points out the prevalence of serious "agency problem" in the existence of which one side of the participants to the economic game will gain against the others. The argument is that inadequate institutions have not only lead to the mal-functioning and severe under-achievements of the system, it has also lead to a situation dominated by the beneficiaries because of the vested interest. This study until now suggests that one reason of the emergent vested interest and increased social cost is closely related to the missing markets, in the existence of which information asymmetries becomes prevalent. This, in turn, results in standard principal-agent problem of moral hazard and adverse selection, or to put simply in economic terminology, a divergence from the Pareto Optimality.

8.6- Conclusion

Japan's post war system was planted under the influence of wartime economy and was further modified after the Second World War. Despite all reformations on the system, developmental premises were retained such as production priorities at the expense of consumers, and social welfare measures. In order to achieve the system's targets, a catch up model was pursued until 1980s, when Japan closed the gap and had become another mature industrial economy. In the process of catch up, the world system, as well as domestic balance of powers enabled Japan to use neo-mercantilist policies with the nation state as the unit of analysis. This system promoted export and restricted the entry of foreigners to the country in terms of FDI and imports. Bureaucratic, as well as corporate practices were the main preventive tools in this isolated structure of the economy.

With the passage of time, Japan's model outlived because of the bureaucratic entrenchment and the fixed systemic priorities. In order to keep the system in track, Japan's response to the external crisis was weak or inappropriate, which magnified Japan's problems as time went on. These chronic problems have first surfaced in the financial indicators, and then spread to the real economy. In the post bubble economy, Japan has been suffering from continuous deterioration of bad-loan problems in the financial sector, over-capacity problems of the previous decades, over-appreciation of the yen, a high-cost structure of the domestic economy and so forth. Despite several emergency (stimulus) packages, the overall effect of these problems has been the substantial hollowing out of the major export-oriented manufacturing industries of Japan, which left behind an inefficient non-export industry, a reduced share of Japan's trade performance, a record level of unemployment, and insufficient domestic demand. Japan's recent situation has been described by Nakatani: Japan, as a whole, is one big convoy of ships under escort. The carrot and stick are applied in a topsy-turvy manner, with the rewards going to the lazy and the punishments to the industrious. Under these circumstances, the bureaucrats of the Ministry of International Trade and Industry can trumpet calls for more entrepreneurship, but nobody is going to listen. People consider it much easier to make money within the existing system by getting influential legislators to arrange for public funds to flow in their direction. Moral hazard pervades the whole country (Nakatani, 1998)

Finally, the central message of this chapter is that Japan's once famous and "effective" developmental institutions, have already turned out to be detrimental for the economic performance of Japan. With the current structures, Japan's developmental institutions are neither "effective" nor "efficient" in resolving major principle-agent problems.

IX- CONCLUDING OBSERVATIONS:
Lessons From the Crisis

Because of rapid innovations and progresses in information, communication, and transportation technologies, the globe has entered an age of globalization in terms of political, economic and social factors. We can mention three overall results of globalization.

First, in the post-cold war era demand for participatory democracy has increased, and the quest for an open society in terms of accountability and transparency has become an international public good.

Second, market mechanisms are dominated in a powerful way over the rest of alternative distributive mechanism such as communism and strong domination of state.

Third, as the new productive edge changed dramatically towards high-tech, high-value-added, and knowledge-intensive industries, old manufacturing systems which were based on mass production technologies and large-scale heavy capital investments, left their places to more dynamic and flexible industries. Besides the flexibility of corporations, this new era also requires high creativity of employees. Creation of such human factor requires market dynamism, individualism, high job mobility, and a merit-based wage system, rather than Japan's employment system which has been identified by specific corporate culture. To recall once more, the basic elements of Japan's employment system are the "company person", surrounded by dual labor market, seniority wage system, life-time employment, group cooperation, diligent working ethics, and so forth.

One of the most important implications of globalization is, therefore, that, regardless of the national culture, history, and political systems, it is unavoidable that there will be further convergence all over the world to one and the same global system. Basic elements of this similarity would include democracy, market mechanisms, and new paradigms of production dominated by multinational corporations. After the recent global crisis, internationalization of production and the global indivisibilies have gained further momentum through large scale mergers, acquisitions, and alliances. This observation suggests that nation states have lost their relevance as the isolated unit of analysis in development. In other words, policies for neo-mercantilism would not be tolerated by the international community, and therefore emphasis will be on the competitive and fair polices.

Unlike the early period of development experiences in the second half of the 20th century, when high growth policies were favored at any cost, by the start of new millenium, however, in the center of economic development priorities will be given increasingly to the once ignored concepts such as, sustainability, equity, and equality. Therefore, the infrastructure of developmental ideology of the Japanese version, which has favored producers, and neglected consumers would not be a viable path.

This way of my reading of the global trends has a set of crucial implications for other developing countries as well as Japan. We have concluded that Japan's achievements are not because of her distinctive national features but appropriate institutions, the consensus on development model, and its ultimate targets, which was the historical drive for catching up other industrialized countries. The second lesson is that Japan's development experience has shown the importance of bringing new technologies and new forms of organizations to the country, and the need for specific institutions designed to raise a country's capability to take advantage of the gap between itself and advanced countries. Japan's industrialization history demonstrates, once again, the need for specific institutions to improve technological absorption capacity and import capabilities.

This does not, however, suggest that developing countries should opt for Japan's style institutions such as cartels and bureaucratic dominance such as MITI and MOF, a result of which Japan has been getting tired of growth at any cost. At the time of Japan's development, world system allowed Japan's drive for technology transportation with strict limitation on the entry of foreign capital and its dominance on the national competitive strategies of the Japanese firms. Today, technology paradigm has been closely embedded in multinational production paradigms.

From the last statement we should shift to the third lesson. Because, the availability of conventional means of industrial polices at the disposal of nation states has been severely constrained by globalization in finance, trade, and production, the need and dependency over public support, therefore has declined drastically. For instance, the emergence of multinational corporations and internationalization of production, have challenged the viability of industrial policies to "target", "select" and "ration" sectors and firms to foster competitiveness of "national" firms in strategic sectors via discriminatory policies. In conjunction with that, it should not be seen as exaggeration to argue that Japan's development model, more or less, has lost its

relevance to be imitated or repeated elsewhere, so as to enable other NICs of the Pacific Rim Countries.

To put the matter the other way around, even if we assume that it could be repeated elsewhere, the propagation of her development experiences to other developing countries would cause crucial negative results for future competitiveness of the Japanese economy. After Japan's model has been shown as a viable alternative accumulation regime, ironically, Japan has also faced its worse consequences, such as the 'national car' policy adopted by Brazil and the challenges of the Southeast Asian countries that directly threatens the interest of Japanese automobile makers.

One irony of Japanese history is that major changes such as the Meiji restoration of 1868, and the post-Second World War reforms were the externally enforced chances upon Japan. Contrary to the Japan's earlier crisis, however, the source of this last economic crisis is primarily a product of domestic structures. Therefore, solutions should be found out from "within" for Japan's third change. Under the pessimistic psychology of the policy inaction, academic and intellectual circles, as well as in the society has been highly doubtful if Japan would be able to overcome this great task of history through its own dynamics without leading to the further external pressures and national crises in the face of growing menace of an economic and political meltdown.

For Japan to escape from the culture of "catch up" model and the ideology of developmentalism, in general, administrative, fiscal, and financial reforms of the 1996, which have already been under implementation should be continued. The ultimate goal of the reforms has been declared as to create a "free, fair, and global" system. This is the long-term target of the system, in the short and medium term, however, implementation of deregulation, decentralization, and transparency measures should be given priority. As a positive note, despite the inconsistencies and weakness of the reform measures, there is no doubt that recent reformation process is in the right direction.

Nevertheless, in order to make any predictions for the march and evolution of Japan's capitalism in the future, the time is early, the process is not complete, and their results are not conclusive at the moment. I have several reasons for my reservation.

First, until the 1980s, when Japan was in the process of catch up, industrialized countries provided a model to emulate and imitate in order to close the existing gap. That is, Japan had ample available sources of relatively "free" experiences which would allow a Japanese style "learning by doing" paradigm. The post-catch up period,

however, is a new and challenging experience for Japan. It is the first time in the history of Japan to initiate and implement any radical and indigenous major political, economic, and social reform by its own initiative without any pioneer. That is, from now on, despite their curious inquiries to find out the similar problems in other countries in order to "learn" how they managed, it is unavoidable that from now on Japan will proceed by "trial and error" method, and it will become a model for the rest of the other "followers". As a consensus society, therefore, sufficient time must past in order to achieve consensus through out the society for the desired route of change and nature of reforms.

Second, although it has become evident that change is unavoidable, proponents of the system such as Sakakibara, currently vice-president of Ministry of Finance, still believe that current crisis was transitory, provided that sound and appropriate macroeconomic policies are implemented with a strong leadership quality. He argues that the Japanese way of "human faced" capitalism is an alternative mode of accumulation regime, and in fact dominated over its western counter-parts. For Sakakibara, for instance, Japan's capitalism is quite consistent with Japanese history and values. Classical capitalism was the aberration in Japan, not the norm; it had existed for perhaps only twenty years or so in the entire history of the country, in the first quarter of the twentieth century. And its short life was inglorious; it had aggravated poverty and created social unrest throughout the country. What is important is to cast aside the 'reform view' based on the outlived-Japan concept and to position Japan as a model or as a civilization in thinking about what direction it will take.

Third, a well-organized and mutually supported triad at the top of the system resists any kind of change against their already established interests, that is *status quo*. This is, perhaps, the most serious preventive force for reforms and institutional change. Recent cross-country studies on institutional change has shown that it would be naive to expect that a society can achieve either efficiency or equity through *comprehensive bargaining among organized interest groups*. This is because some groups such as consumers, tax-payers, the unemployed, and the poor do not have either the selective incentives or the small numbers needed to organize, so they would be left out of the bargaining. Among them, it should be noted that the beneficiaries of the existing system have the capacity, capability, and resources in terms of finance and political power to be organized in order to get benefit of opportunities created by recent crisis and implemented reforms.

Based on this premises, the chance for Japan to attain symmetrical organization of all groups with a common interest and thereby attain optimal outcomes through comprehensive bargaining is limited and outcome should be seen later. What is certain, however, is that depending on the nature of asymmetric information and the cohesiveness of the interests among people, in the future highly different forms of organizations and institutions would emerge for collective action in order to maximize jointly defined group interests or utility function over time. Since any of the reforms will have distributive consequences, different groups affected by regulation-firms, industries, employees, consumers, or public action lobbies - have incentives to seek regulation that benefits them and resist the ones that hurt them. As a result, regulation may induce collusion via clientalistic ties between the regulators and the regulated groups. The Bridge Bank project and government reliance on public funds to solve big firms' bad loan problems can be seen as a signal that the triads at the top of the system are still robust to use the benefits of reform measures and strongly resisting against any radical change in the existing system. More concretely, the Ministry of Finance, for instance, has been accused of not being transparent enough in using public funds to rescue banks from their bad loans. The ministry was warned for the woes of the Industrial Bank of Japan and the Japan Credit Bank several month before, but the ministry denied all these accusations until when it became impossible to hide the mountain-like bad loans from the population.

Although it was expected that in the post-bubble economy, due to the collapse of the stock prices, interlocking share ownership would decline, this expectation did not materialize, mostly, due to successful diversification of keiretsu groups into the financial sector rather than productive activities. Despite a recent surge in foreign capital inflows to Japan's inefficient financial sector in the forms of alliances, mergers, and even acquisitions, there is no guarantee that this would contribute to the lessening in the interlocking shareholding system because of three reasons: First, even foreign owners would like to get benefit of the existing system from which they were excluded in the past. Second, perhaps the worst, the existing beneficiaries would resist any radical change in the system, and at this time they would collude with foreigners in order to preserve their status. Third, since the establishment of holding corporations were recognized in 1998, there is an increasing pace of mergers under holding corporations, whose outcome can be predicted from the view point of consumers, workers, and

depositors. Considering this aspect of the problem, one should not expect radical, fast, and persistent transformation in the "corporate capitalism" of Japan.

In Japan, the ministries which were responsible for the trade-averse, secluded sectors have been the home of interventionist policies, promoting the development of domestic industries under their jurisdictions, thus continuing the bureaucratic tradition established after the Meiji Restoration of 1868. As a late comer nation, government ministries and agencies were created as task oriented mobilization and development agencies whose main function was originally to quite Japan's rapid forced developments in order to forestall incipient colonization by western imperialists. That is to say, their current predisposition towards controls are *strongly path dependent.* This suggests that any possibility of change in developmental institutions of Japan take place in an evolutionary path and will naturally be time consuming without any deep radical challenges from within or outside (Mochizuk, 1994).

Whatever would have been the situation in the future, we still retain the connotation that the choice of institutional framework has consequences for the allocation of resources (efficiency) in the economy, because of the fact that differential in performance between economies are the result of differences in the efficiency properties of the right structure or the institutional framework chosen, or created as a result of conflicts between different interest organizations.

Before going on my suggestions, it should be appropriate to make a couple of warnings concerning the ideological and philosophical underpinnings of my perspective. The current problem we face in Japan is not of "the market" versus "the state", but of specific-institutions that would induce individual actors-whether economic agents, politicians, or bureaucrats- behave in a collectively beneficial manner. Also, the question is not whether institutions matter, a question that should by now be obvious, but rather how institutions matter in term of the incentives and disincentives they present to actors. For public works, for instance, key institutions in Japan are the government procurement system, the civil service employment system, the electoral system, and the political party system. They together would affect the structure of the policy making process and instructions among political élites.

The spirit of an ideal reform procedure from the current topics of institutional reform is that if government is to perform well, the bureaucracy must be effectively overseen by the elected politicians. They, in turn, must be accountable to the citizens. In reality, as the effectiveness of institutions can not depend merely on the good will or

discretion of people who populate them. Good will such as strong nationalist sentiments and patriotic feelings, should also be complemented with other "checks and balance" elements such as sound legislative mechanism, implementation procedures, accountability to the people and transparency. The chance for reforms to be implemented depends, first, on the capability, capacity, and the willingness of ruling élite to make necessary reforms in order to eliminate the long-lasting hegemony of already established interest groups composed of LDP diet members, bureaucrats and big business. Thus, Japan may want to consider breaking up the powerful ministries, paying retiring bureaucrats adequate pensions in order to curtail the practice of *amadakuri* (having been employed at big firms as a top level manager after retiring from the main bureaucratic posts), and strengthening the office of the prime minister by providing adequate staff and budget so that the prime minister is not totally dependent on the bureaucracy for information and drafting of legislation and regulations. The prime minister could also be given more power to dismiss top-level officials and to appoint his own supporters to key bureaucratic positions.

The second determining factor on the effectiveness of reforms is the awareness of people for their rights so as to increase their "voice" for resisting to the established interest coalitions. Nevertheless, because the culture of political opposition has been eradicated, and the channels for opposing views was curtailed through several means of "social engineering" and legislative measures in the last half century, the hope for any "endogenous" source of change is still very limited.

Revitalizing the political system, therefore, would automatically lead Japan in the direction so as to cure its economic ills. Of great importance is the role of the judiciary. The ability to take the government to court, to resolve disputes outside the ambit of special relationships, to obtain a speedy judgment in the context of clearly defined procedures is absolutely essential for the underpinning of a modern, democratic, market-oriented, capitalistic society. All this, of course, is aimed at empowering citizens and their elected representatives, but meaningful elections require true political competition. Thus, development of strong, competitive political parties is a matter of the greatest importance in Japan.

For an appropriate reform process, the privileges of the system must also be reviewed. As the post-bubble crisis has shown in a dramatic way, the "save, invest and export model" of Japan in the process of catch up has outlived its time. Japan needs to become a major consumer-oriented society, and that means changing the incentives by

fully taxing interest and dividends earnings, encouraging housing by allowing mortgage interest deduction from taxes and greatly liberalizing land-use regulations, breaking up the cartels that effectively dominate non-export sectors of production and distribution of many consumer products, and extensive deregulation of heavily depressed sectors such as airlines, inland transport, telecommunications and energy. Illusions of Japan's success until the 1970s, that is two decades of rapid growth, gave the Japanese the hubris to believe that the normal rules of economics did not apply to Japan, which they believed to be "different" than other countries. If Japan had not grown quickly in the 1960s, it would have been bombarded with intellectual and academic society missions recommending that the Japanese dismantle many of the institutions that now appear inefficient. In that sense, Japan's failure teaches us that economic growth should not fool one to forget about merits of openness, competition, transparency, equity, sustainability, and some other societal welfare considerations because of the fact that when economic growth slows down, which is inevitable, under the emerging political stalemate and economic meltdown implementation of any radical structural reforms would be more difficult, if somehow possible, then much more painful.

The relevant institutional lesson is that institutions are our adaptive tools to cope with the emerging problems, they might be totally inadequate in the test our society faces tomorrow. This suggests that perpetuity of economic development as an instituted process requires to create a proper set of social institutions in a dynamic setting and to avoid the obsession of the old institutions. From Japan's perspective, this should be considered as the most important policy implication concerning the history of institutional change.

Although it is true that the existing rent-seeking interest coalitions are resisting to any radical change in the system, Japanese capitalism will, however, converge because the necessity of change has pervasively dominated. Among these pressures, conjectural shortcomings, systemic failures, and global challenges can be cited. Among the visible signs of convergence, foreign trade measures are important indicators. For instance, Japan's increased imports, particularly in manufacturing imports and increasing rate of intra-industry trade are among the strong evidences of convergence (Menon, 1997). Data on unemployment, real wages, and number of corporate bankruptcies shows that economy is becoming increasingly responsive to the market forces parallel to the implementations of reforms. Moreover, employment relations, particularly, in financial sector and large corporations, show an early sign of change

towards more competitive, flexible, and merit-based labor practices in order to reduce cost of fixed-labor costs, and increase employee performance by flexible and creative-minded labor force. Finally, there has been also a surge in foreign acquisition, mergers, and alliances in Japan, which implies that inter firm relationships, as well as employment practices, are converging through a hybridization of the Japanese and American models (Koike, 1998).

On the other hand, despite the recent changes and reforms in the existing system, under the current uncertainties and contingencies, the meaning of this change for the Japanese as well as the foreigners has not been clarified yet. Moreover, there are several supportive elements for behalf of convergence in the developmental model of Japan towards the western type of market economy after the implementation of several reforms in administrative, financial, and political systems, it would, however, be early to expect that this convergence would a permanent characteristics of the "newly emerging" system. As Yamamura (1997) has also shown, this convergence, however, might be limited to some particular sectors or it might take place temporarily and be reversed as the pressing needs are weakened. Despite these observations on behalf of convergence, however, my final judgement is that the system is unable to make substantial changes in the near future because of the strength of its embedded institutions.

According to my overall "perception" of Japan's modernization history and my own findings in the current study, what I would argue is that despite several similarities, *convergence* and *catch up* are not the one and same thing. Without doubt, by the turn of the 1980s, Japan became successful in her aim to catch up the west in terms of any criteria of economic growth and industrial phenomenon. At least one and a half decade has past since then, however, Japan's system remains still "different" than of the western model in several other aspects such as corporate practices. Therefore Japan, purposefully or not, would reinvent the old slogan of "Japan is different" in order to reap the benefits of not being criticized under the world wide criteria. Japan would also like to retain such a "Japan residual" in order to keep its national harmony by preventing any easy access of "outsiders" to the system and thereby preserving her existing competitive advantages in favor of "insiders", that is the major beneficiaries of the system

What this observation would simply suggest is that Japan will change not because it is demanded by the westerners, or because they have started believing in the

merits of an "open society" in the western sense, but because they have also realized that there is no available chance for pragmatic use to eliminate existing problems.

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