



## Learning from the Japanese Economy

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Despite recent improvements, Japan today still faces some of the same structural problems that triggered its 15 year economic malaise including low productivity growth relative to the past, continuing high consumer prices for basic necessities such as food, and record post-war unemployment rates. Japan's post-war economic rise and its current relative stagnation offers students and teachers opportunities to both learn more about Japan and better understand economic concepts. Through understanding recent Japanese economic history, students gain knowledge about what causes economic growth and the relationship between economic flexibility and continuing prosperity.

Although the rise of China has major international implications, the fact that Japan remains the world's second largest economy is another important reason that it should be a topic for study in American classrooms. Also, Japan and the United States have an extensive relationship with each other. Although the United Kingdom is the leading foreign direct investor in the United States, each year Japan ranks among the top five countries in investment in this country.

### THE JAPANESE ECONOMIC MIRACLE

After World War II, East Asia was the only region of the world that experienced continual substantial economic growth and no other East Asian country enjoyed more economic success than Japan. The Japanese economic pie grew at an annual rate of ten percent from the mid-1950s until the Arab oil shocks of the early 70s. The Japanese then managed to maintain much more modest but steady growth rates until the early 1990s. Many factors contribute to economic growth, and although some reasons are more important than others, economists and economic historians agree that all of the following contributed to Japan's economic rise:

**State-Assisted Capitalism.** In the early 1870s, shortly after the Meiji Restoration, Japan's new political leadership faced the problem of Western imperialism. Japan's oligarchs quickly decided to build both a strong economy and a strong military. Meiji leaders systematically studied various economic models and made the deliberate decision to adopt a Prussian-style government-directed capitalism where the government plays a significant role in determining what is produced and allocates capital through control of the financial system. Free trade is considered harmful much of the time. The legal framework is considered subservient to state interests and, most importantly, the economy is viewed as existing to serve the interests of the nation, not the individual. The Japanese rejected the Anglo-American laissez-faire model in which the market largely determines what products are produced, and banks and the stock market allocate capital. Free-trade is considered highly desirable. Business and government are viewed as separate entities, and the legal framework (or rules of the economic game) is considered important. Above all, the economy is viewed as serving the individual not the state. Through great state assistance to a few industries, Japan had become, even before World War II, a world leader in aluminum, ship building, and rayon. While Japan's defeat in World War II meant a radical de-emphasis of the military, the

Japanese continued to pursue the goal of economic strength. After the war, the Japanese government continued its practice of promoting and protecting particular industries and discouraging foreign and even domestic competition. These policies were achieved first through tariffs and later through so-called informal trade barriers such as environmental or consumer production regulations written in a way that excluded foreign or even aspiring domestic firms from entering new markets.

**The Occupation.** Although the occupation of Japan did not result in the kind of rebuilding Europe experienced under the Marshall Plan, American-introduced policies resulted in higher Japanese savings rates and lower inflation.

**The Korean War.** While the U.S. did not defend South Korea with the intention of helping the Japanese economy, massive American purchases of goods and services during the war served as a major economic boost to the still-recovering Japanese economy.

**The World Free Trade Boom.** Due in part to the post-war climate engineered by the U.S. and Britain, free trade substantially increased relative to the 1930s, creating a favorable situation for Japanese exports.

**Shift From Dependent to Less Dependent Industries.** Before the 1950s, a number of leading Japanese industries, epitomized by textiles, were heavily dependent upon expensive raw materials. By the latter part of the same decade, the Japanese were producing goods such as cars that required fewer imports. This made Japanese exports less expensive. Even though Japan's miracle was not exported and the country did not begin substantial exporting until the 1960s, when the export boom did occur in Japan, it made a strong economy even stronger.

**A Surplus of Well-Educated Workers.** As late as 1950, fifty percent of Japan's population lived on farms. Japan's excellent schools and a high birth rate placed employers from the 1950s until the late 1960s in the enviable situation of having a large supply of young, well-educated, rural high school or junior high school graduates who were no longer needed on farms and who desired industrial employment.

**Surplus Funds for Investment.** Private savings, which banks and other financial institutions in turn lend to expanding businesses, are extremely important for economic growth. Japan's high savings rates enabled Japanese industrialists during the miracle years to obtain massive amounts of funds for expansion very cheaply.

**Trade Union Structure/Industrial Relations.** Japan has industrial rather than craft unions which means management negotiates with one rather than several labor unions. Also, lifetime employment in major industries, a seniority system where people are rewarded eventually if they remain with one company, and worker participation strategies all have contributed to harmonious and productive Japanese work places.

**Competition and Entrepreneurship.** Even though the government played a larger role in the Japanese economy than was the case in the United States, domestic private competition in such industries as motorcycles, automobiles, and consumer electronics was fierce. Successful Japanese entrepreneurs in these, as well as other

industries, were able to build powerful companies that benefited the entire economy.

**A Stable Political Situation.** During the miracle years, the voters continued to elect members of one political party, the Liberal Democratic Party, thereby avoiding the political unrest that hurt the economies of other nations during this time.

**Low Military Expenses.** While Japan today has one of the largest armed forces in the world, because the U.S. viewed Japan as strategically important during the Cold War and thus shouldered a major portion of the costs of Japan's defense, Japan was freed from the burden of spending a large portion of its wealth on its military.

### JAPAN'S RECENT ECONOMIC PROBLEMS

The most important lesson to be learned from Japan's decade and a half economic stagnation is that circumstances change quickly, and if a system is incapable of adjusting to those changes well, the economic quality of life will certainly suffer. This is what occurred with the Japanese system of state-assisted capitalism.

During the miracle years, Japan had few economic competitors in Europe and none in Asia. Because Japan was a Cold War ally, the United States ignored Japanese policies that discouraged imports. The situation is now dramatically different. Japan faces strong international competition. Although the U.S. government is not as concerned about trade issues as prior to the War on Terror, it periodically is critical of Japan's barriers to imports. Protectionism makes life worse for most Japanese. Also, as a result of the communication and computer revolutions, the very nature of global economic competition has changed. Companies now must make swift business decisions in order to remain competitive. While there has been moderate deregulation, Japan's relatively inflexible economic system still makes it difficult for Japanese companies to respond as quickly to competitive challenges as their foreign counterparts. In the face of dramatic new economic challenges the Japanese system continues to change much too slowly.

For example, the typical Tokyo family spends about one third more of its household income each year on food than that of a New York family in part because of informal and formal trade barriers that still keep much foreign produce out of Japan. The ruling Liberal Democratic Party and bureaucrats friendly to the farm lobby are responsible for this situation. Even though Japan's full-time farmers constitute a miniscule percentage of the nation's workforce, they are solid LDP supporters and have been protected from foreign competition as consumers suffer. Government protection of highly inefficient industries such as construction and food processing wastes resources and causes Japanese individuals and firms to pay much more for products than would otherwise be the case. In an effort to secure political support from the construction industry, the LDP often supports useless public works projects thus increasing Japan's already high-government deficit. Because until very recently large Japanese companies would not lay off permanent employees, many Japanese industries still have high costs compared to companies in other developed nations. However, Japanese companies are now significantly changing employment practices in order to again become healthy.

During the 1980's Bubble, Japan's state-directed banking system made an enormous number of loans to non-productive companies, who are still unable to pay them back, which has created a credit crunch for potentially strong firms who need capital. As of 2004 the large majority of economists and policy makers concur regarding what reforms Japan needs and there are definite signs of progress. Japan has entered into agricultural free trade agreements recently with other nations thereby weakening the excessive power of farmers. Although the nonperforming loan problem remains

substantial, the total amount of bad debt has been reduced. Also, even though the amount is very low by the standards of developed countries, Japan is increasingly open to foreign investment. Still, much further reform must occur before the Japanese economy returns to full health.

An increasing number of Japanese and foreign observers believe that the only long-term solution to Japan's structural economic problems will be the rise of a political party strong enough to wrest power from the LDP thus ending the excessive coddling of special interests groups at the expense of the nation's economic health. Recently the Democratic Party of Japan (DPJ) won impressive gains in national elections. Although they do not need to "become like us," the Japanese should move more in the direction of freer and more unregulated capitalism and away from the still somewhat inflexible state-directed system that was created to solve a different set of economic problems than the ones that exist today. These reforms must continue to progress because demographic changes in Japan's population also threaten the nation's economic viability. Very soon Japan will have the highest percentage of citizens over 65 of any developed country. Already, because of an almost-twenty-year baby "bust," Japan's population is growing at a mere 0.08 percent (estimate for 2004) and may soon start declining. The most effective way to combat the enormous cost of these demographic changes is through impressive economic growth. Because of Japan's massive global impact, the world will be better off if Japan again becomes an economic engine of growth. Meanwhile, American students can learn much about an important country and about economics from Japan's successes and failures.

For further information please consult the following sources.

### RESOURCES

#### Books

- Katz, Richard. *Japanese Phoenix: The Long Road to Economic Revival*. New York: M. E. Sharpe, 2002.
- Lincoln, Edward J. *Arthritic Japan: The Slow Pace of Economic Reform*. Washington, D.C.: Brookings Institution Press, 2001.
- Mak, James, Shyam Sunder, Shigeyuki Abe and Kazuhiro Igawa. *Japan: Why It Works, Why It Doesn't, Economics in Everyday Life*. Honolulu: University of Hawaii Press, 1998.
- Nippon Nyumon: An Idea Book for Teaching Japanese Economic Topics*. Bloomington, IN: National Clearinghouse for U.S.-Japan Studies and ERIC Clearinghouse for Social Studies/Social Science Education; Washington, D.C.: National Council for the Social Studies, 1999.

#### Periodicals

- Foreign Affairs*, 58 East 68th Street, New York, NY 10021.
- Far East Economic Review*, GPO Box 160, Hong Kong.
- Education About Asia*, 1021 East Huron Street, Ann Arbor, Michigan 48104. <http://www.aasianst.org/eaatoc.htm>
- The Oriental Economist Report*, 30 East 20 Street, #202, New York, NY 10003.

#### Web Sites

The Institute for International Economics: [www.iie.com](http://www.iie.com)

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