# The Collapse[1] of the Riskless, Middle-Class Economy

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## Abstract

*The very basis of Japan's post-war economic growth was time and place specific. A fundamental failure to recognise the temporary nature of Japan's success led the Japanese to make ad hoc changes, which served largely to prop up the prevailing status quo. Inevitably, Japan's ability to sustain the level of growth required to maintain its economic system periodically faltered, before collapsing in the nineties.*

> Since capitalist enterprise, by its very achievements, tends to automatize progress, we conclude that it tends to make itself superfluous – to break to pieces under the pressure of its own success. The perfectly bureaucratized giant industrial unit not only ousts the small or medium-sized firm and 'expropriates' its owners, but in the end it also ousts the entrepreneur and expropriates the bourgeoisie as a class which in the process stands to lose not only its income but also what is infinitely more important, its function (Schumpeter 1950: 134).

By his own admission, Joseph Schumpeter is said to have harboured the startling desire of becoming the world's greatest horseman, the world's greatest lover and the world's greatest economist. Unfortunately, life, as it turns out, is seldom what you would have ordered up from room service. Though successful in conjuring up a romantic persona to brave a scornful world, Schumpeter's relationships with women verged on the tragic. Despite his strong-grained Viennese heritage, he later regretfully admitted to a lack

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of empathy with horses. Sadly, his luck as an economist proved to be no better. His own seminal work (Business Cycles 1939) of the thirties was largely submerged by the tide of Keynesian economics. A final effort to create a career as a prophet, retrospectively provided no unambiguous or lasting success. We are still awaiting the death of the entrepreneur, glimpsed by Schumpeter as an inevitable evolutionary result of economic development.

Strangely enough, although *Capitalism, Socialism and Democracy*, was widely read during the post-war period, only the Japanese, and to a lesser extent the Germans, seemed to have taken Schumpeter's message to heart. In essence, the Japanese developed a corporate economy that sought to automate innovation and remove not only the bourgeoisie as a class but the idea and reality of class itself. In a sense, where Schumpeter's work, if believed, necessarily chilled the souls of conservative businessmen in the US or even the UK, the same message gelled nicely with the vision held in common by Japan's traditional leaders, including its pervasive business class. Automating change into a reliable productive input would largely mitigate, if not render nugatory, the whole problem of risk. With informational blockages eliminated, or at least reduced, predictability would increase.

An economy of this type, managed by a bureaucracy that depended on personal if not feudal relationships, would guarantee regular, perhaps even, rapid economic growth. With the ensuing benefits spread in a sufficiently strategic manner, historical class conflicts would be definitively undermined by essentially eliminating distinguishable classes. Potentially disruptive elements could be tempered by judiciously spreading the soothing economic balm produced by the offshoots of growth. Every Japanese citizen, who wished to, would be able to have a place in such an all-inclusive society.[2] The Japanese came to believe that they could capture the strengths of Schumpeter's vision without suffering any of its inherent weaknesses. By a strategic redistribution of wealth, they could maintain economically inefficient elements and structures that nonetheless provided the institutional support for capitalist production. The key to inhabiting comfortably within, rather than being crushed by, the world Schumpeter constructed was a flow of inherent and irrefutable wealth with which to ease all the inevitable frictions produced by economic development. In a regime characterised by such a compelling objective, growth becomes an end in itself. Without dependable waves of wealth the economy and society so constructed could not survive intact.

When growth faltered in the nineties, the nature of the economic miracle that Japan had wrought began increasingly to be called into question. The transformation of the Japanese economy from 'miracle' into 'catatonic' has

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produced an unnecessary bumper crop of works retrospectively pointing out Japan's errors, especially in respect to the conclusive long run dominance of market competition. Revisionism is no doubt entertaining. Moreover, many of these works contain within themselves elements of truth and insight. They lack, however, a coherent framework, or at least one that is specific to Japan rather than characteristic of an abstract, more generalised economy.

> In this sense it is erroneous to assume unconditionally that one can construct an economic model in the abstract and apply the logic of the model to the realities of a country (Morishima 1982: 201n).

If one dismisses history and other institutional constraints, this poses no problem. But all such approaches lack a compelling argument that can convincingly explain the undeniably remarkable post-war Japanese success. To say that Japan could, or even would, have done better if it had followed an alternative path, is a counter-factual that strains belief. A comprehensive, alternative approach that acknowledges Japan's post-war constraints needs to be offered instead.

Providing such an explanation begins by considering the role that risk plays in determining economic events, as well as in the inherent attitudes that characterise risk bearing. Risk is fundamental to any theory of contractual relations. In a world of limited asymmetric information, the attendant risk of contractual commitment can often inhibit potentially fruitful exchange. Without being able to specifically pinpoint gains and costs, nor to rule out opportunistic infringement of property rights, the attendant risk inherent in any contractual arrangement makes subsequent attempts to reduce risk, and to reallocate it, critical. Whether consciously or not, the Japanese made risk reduction the focus of their economic policy. In doing so, they underestimated the mirror problem presented by risk allocation. Changing risk does change incentives. It can in fact promote a lack of needed responsibility as well as stifle needed innovation (contrary to Schumpeter's predictions). In some ways the Japanese were so obsessed by the Scylla of adverse selection that they lost track of the equally treacherous Charybdis of moral hazard. They established a system where economic agents were encouraged to contract, but one which lacked the accompanying accountability that specifies the appropriate responsibility connected to assuming risk. In essence, a system where risk is shifted to a collective entity has an inherent Achilles heel. Joint responsibility can mean an absence of individual responsibility. Where everyone is willing to share blame, no one individual actually needs to do so. In that particular sense, collective responsibility undermines an important element of property rights. Here perhaps is where Schumpeter most accurately saw the consequence of the Japanese post-war strategy, even though he failed to analyse the problem specifically in terms of risk bearing.

I suggest that Japan's post-war economic history and current problems, can best be viewed through the lens of risk management, as can the attempted evolution of Japanese society toward a classless state. To do so I will need to explore:

- Why the Japanese focused on risk
- The consequences of this focus
- Why it led to Japan's current problems.

## I. Can Demography be Destiny?

> It always comes down to space. Australians find it difficult to imagine just how small homes, shops and restaurants can be. You are mostly so close to other people that if you're not careful, you'll be knocking things over, getting in their way, intruding on their psychological space. But once you get used to it, you start to appreciate how it is that so many people can live so close together in peace, and it is a revelation (Highbridge 1999: 86).

Culture is an explanation that simultaneously manages to explain too little and too much. Any observation that deviates from a prescribed norm can be reduced to some intrinsic characteristic that describes the people and institutions of a specific country. It has for that reason found little favour with economists who prefer theories and concepts that lead to potentially measurable variables. However, even the most sceptical of economists would give credence to the ideal that the same incentives will not have the same effect on all people. If, as Becker and Stigler (1977) have argued, appeals must be directed to a given set of preferences, then unless we assume that preferences are globally the same, in which case only the relative constraints are of any consequence, then it makes little sense to dismiss out of hand the possibility of distinguishable national differences. Given this framework, the task is to explain these characteristics rather than ignore them. For the post-war period, the real challenge is to first analyse the tendency of the Japanese to be highly risk averse as a group. Such a trait, becoming, in effect, an embedded and seemingly immovable stance, must be linked to the way in which the prevailing group of corporate, political, and administrative leaders devised a set of incentives that were consistent with a broad range of economic objectives. Post-war Japan did not take a path pre-determined by their culture but one constructed to be consistent with certain leading elements of that culture. Part of the success of the 'miracle' economy depended upon a synchronisation between cultural beliefs and economic practise.

The most plausible way to explain distinctive attitudes and concerns about risk is to look back on an economy's developmental history. Again, this doesn't lead down any deterministic path but instead explains the potential characteristics that could be channelled to achieve, under the right circumstances, a specific set of objectives. Like all countries, economic development in Japan has been influenced heavily by demographic and geographic constraints. It is hardly an exaggeration in Japan's case to suggest that its demography has been its destiny.

> Seen from a historical view there has been in Japan the sense of a country limited in land, terribly poor in resources, and subject to an exceptionally unpredictable and violent geographical environment. It is not surprising that under these conditions there would be a need to husband limited resources and invest those resources carefully. A strong preference for security over risk would be a natural response (Abegglen and Stalk 1982: 210).

Though Japan has a total land area of 377,837 sq. km. (1995) only 13.6% is cultivated. Most of the country remains uninhabitable forest and grasslands (67.2%) or waterways (3.5%). The history of Japan then has always been a case of too many people (126,892,000 1999 estimate) living on too little land, or in purely economic terms a country chronically rich in labour resources but traditionally capital poor. Without any natural resources of note to fall back on, the Japanese have over the centuries come to see themselves as a country lacking the luxury of being able to afford to make mistakes. Unless they were highly self-reliant and inordinately careful, all would be lost. They placed their faith in their own intelligence and skills, looking for answers within rather than relying on any advantage that could be garnered from the world at large (except at critical junctures during their history). The extended family or clan became a metaphor for Japanese society and the Japanese economy as well. The clan looked after its own members and opposed any intrusion from outside. Change became a threat to contain, or at best manage, rather than presenting itself as an opportunity to exploit. Such a response has led inherently to an intrinsically conservative, or highly risk averse approach, to economic decision making.

In contrast, the US has been a country of great mobility, capital rich and labour poor. Lacking a history, particularly a feudal past, it also lacked any aristocratic class that could be transformed into a ruling bureaucracy serving king and country as occurred in so many other industrialising countries.[3] The ability to 'light out for the territories', in the words of the archetypal American hero, Huck Finn, provided Americans with options which more settled countries were at a loss to offer.

American entrepreneurs were risk-takers par excellence. This refusal to play it safe, and a certain willingness to shave margins experimentally close, gave the US a competitive edge. But it was the peculiar circumstances and origins of the country that provided a form of economic flexibility based upon an individualistic culture that was in turn conducive to a continuing drive for economic efficiency. In some ways the early US was the embodiment of an Adam Smith-like society. Vast territories and a scattered population provided a blank slate in lieu of a structured economic environment. Flexibility grew out of an assumption of unlimited opportunity. Namely, a given belief in the ability to start over emboldened individuals to undertake risky enterprises. A failure in one activity could later be counterbalanced by success in another. In contrast, options were limited if not non-existent for the Japanese of the Tokugawa period. Japan provided tightly prescribed roles defined by mutual relations within a family-like organisation. If the US became a nation of laws where property rights and relations dominated, Japan was equally characterised by the somewhat arbitrary rule of men and thus inevitably by personal relations.

The Meiji Restoration supposedly changed this, but not to the extent that it might be supposed. Change was forced upon Japan and change came from the top down. Although the country rapidly industrialised and even Westernized, something of the previous feudal or clan like structure remained. Japan saw industrialization as necessary for survival against a pressing and explicit foreign threat. To cling senselessly to the status quo would leave Japan as vulnerable as China to Western domination. But an economic transformation under these circumstances was not an internal class revolt against the existing power structure. The dominant cultural myths need not be displaced. Instead, under the guidance of a newly restored and powerful emperor, they could become the engines for rapid industrialization and capital accumulation. Besides, viable alternatives were notable by their absence. The peasantry was too dispersed and powerless to present a sustained challenge. Nor did the ruling caste have to contend with a burgeoning commercial class. With the extended closure of foreign trade, merchants had become dependent on the government for the smooth function of internal commerce. They required a blind eye to be turned and a willingness of government officials to deny reality when it suited their purposes. (A practice that has continued in various manifestations up to the present day.) The marketplace with its reigning power embodied in the price mechanism would, of necessity, be subservient to issues of obligation due to the State. The invisible hand would have to defer to perceived national imperatives.

The Meiji Government attempted to incorporate new industrial technology within the existing social structure, in this way taking full advantage of long-standing hierarchical relations. This program gained currency under the slogan of combining Japanese spirit with Western ability (*wakon yosai*). Under State guidance, the unified people of Japan could be carefully shepherded and quite blatantly squeezed toward completion of this monumental task. Adapting a Western ideology of individualism too freely, would dilute this concentrated force by turning some of the potent massed energy inward instead of directing it toward the defeat of foreign competitors.

The issue is whether there has been a continuity in Japan's industrialisation process that reflects the tightly controlled, command economy of the Tokugawa era that provided two and a half centuries of stable peace. A key and perhaps a neglected element of this period is the importance of information in controlling change and thus reducing risk.[4] Essentially Japanese rulers were willing to forego economic development, which in their eyes could only ferment additional risks, in order to maintain the hierarchical status quo. But, the existing Tokugawa system was itself prohibitively expensive to monitor. The trick was to get people to self-monitor, or lacking this, to get groups or clans to accomplish the same self-monitoring. Group responsibility denied the individual a separate role and the Tokugawa rulers enforced this approach by utilising group punishment. The drive to substitute collective for individual risk has a long history in Japan. My contention is that post-war Japan added to this objective of consistently lowering and reallocating risk, by introducing an equal determination to broaden the societal middle class. Logically, these two characteristics when judicially combined, could effectively prevent the sort of slide from capitalism to socialism prophesied by Joseph Schumpeter.

An alternative analysis would grant Japan distinctive economic institutions but see them as largely a response to market conditions.[5] Under this framework, the Meiji Restoration marks a real break with its feudal past. Elements of a command economy are then only introduced in the pre-war thirties in preparation for all out war (encouraged by the need to maximise designated production rather than profits). Noguchi (1998) has forcefully argued this very hypothesis, denying anything intrinsically Japanese about such a system. In this vision, Japan, faced by undeniable necessity, changed in the thirties and therefore can change with equal facility given its current crisis. Noguchi depends upon a particular reading of the interwar years to document this. But these years were if anything atypical. The country was fiercely divided between rural conservatives and the increasingly urban and liberal rest of the population (by 1920 it was split fifty-fifty). Perhaps with reliable economic growth, liberal parliamentary democracy eventually would have flourished. But the twenties, Noguchi's westernised decade, was a period marked by the slowest growth rate recorded between the years 1880 and 1940. As in the Weimar Republic, the Japanese people sought stability and an end to economic deprivations after a rather tumultuous decade. (The period was noted not only for its westernised factories and culture but for political assassination, the great Kanto earthquake, rice riots and an inability to curb military ambitions.)

Given that the sort of westernised system Noguchi refers to as typifying the 1920s never dominated the whole of Japanese society, it is perhaps unwise to look at the 1940s system merely as an aberration. Whether it represents some hard to define norm is much more debatable. But elements of the post-war economic structure do seem to have strong roots in Japan's historical development that sharply distinguishes it from the development of a country like the US. Rather than attempt to delineate these rather murky and unsettled issues, it is perhaps more useful to see how the elements of this 1940 system attempted to remove those risk created obstacles which could potentially impede production. Risk as a collective responsibility underpinned the achievement of a desired level of economic stability. Surrendering economic freedom was simply the price paid for reliable economic security. At its heart lay a feudal mindset that deftly substituted a clan-like governance system for one dominated by market relations. Starting in the 1930s, this system, which was only gradually imposed, borrowed elements already dominating the Japanese economy and the Japanese character to redefine policy objectives. These elements were then cultivated while letting incipient moves toward more western contract relationships, liberal property rights notions and parliamentary democracies, wither.

## II. The Canute Complex

> The trouble with the Japanese is that they have never really caught up with Adam Smith ... They believe ... that you cannot get a decent moral society, not even an efficient society, simply out of the mechanisms of the market powered by the motivational fuel of self-interest, however clever or even divinely inspired, those mechanisms may be. The morality has got to come from the hearts, the will and motives, of the individuals in it (Dore 1986: 1).

Unlike the misunderstandings of the story, the legendary King, Canute, never hypnotised himself into believing that he could command the ocean tides, forcing them to turn back against their wont, but simply wished to teach a lesson to professionally sycophantic courtiers. The Japanese however thought they could roll back the tide of risk and spent many post-war decades constructing dikes against inevitable outbreaks. Successive governments appealed to traditional group morality to ward off a rising tide of individualism, first in re-establishing the 1940s system in the years immediately following the war and then in trying to neutralise the effects of increased success and rising wealth. We can summarise the 'Canute Complex' as characterising an economic system with the need to channel and control change. This categorical compulsion leads to an increasingly complex and jury-rigged structure lacking in overall flexibility. The system is sustained by the belief that if change is left to dominate the economy, then risk is inherently embedded in its structure with uncomfortable and unpredictable results.

By using three main levers the increasingly militaristic Japanese government of the thirties tackled the problem of imposing order on a fractious and failing economy. The means were:

- assured demand through rapid military re-armament
- reorganisation and increasing control of the financial sector
- change-over in the corporate governance structure.

In a war-time economy, or one gearing-up for war, the major problem is trying to maintain and/or rapidly increase production. This is equivalent to producing to order (essentially defence oriented goods) rather than producing for the market. The Japanese government needed to reconstruct the economy so that heavy industry could provide an expanded array of war materials. This required a rapid mobilisation of capital. The government of the day eased a potentially binding capital constraint by shifting corporate finance from a system largely dependent on equity issue and retained earnings to one almost entirely based on bank finance. By doing so, the government could funnel investment to directly achieve its ends. Banks became mere conduits of funds, while shareholders lost any real ability to hold corporate managers to account.

In 1904, 1521 banks plied their trade, although only 63 of these had a paid in capital larger than ¥1 million (these banks represented 43 per cent of all bank equity).[6] By 1925, not much had changed with 1515 banks still in existence. However, the financial crisis of 1927, followed by an ill-judged effort to return to a gold-based standard (1930), led to rapid financial concentration. At the end of the war (1945) only 61 banks remained. Part of this concentration was the natural response to financial crises starting with the stock market collapse of 1920 and culminating in the financial difficulties of 1927. Part also reflected the havoc caused by the great earthquake in September 1923. But following 1927, much of the consolidation was hastened deliberately by the government. The Banking Law, implemented in January 1928, stipulated a minimum amount of required capital (¥1 million for most

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banks and ¥2 million for those in urban areas). Failing banks were pressured to meet those standards or merge. Any government, no matter what hue or harbouring what objectives, might have followed a similar path. However, the success of the military in seizing control meant that such measures would be pushed further, taking on specifically fascist goals, especially that of rearmament in preparation for military adventures.

In the latter half of the thirties, the Ministry of Finance actively encouraged and even directly proposed bank mergers in accordance with the 'one-prefecture, one-bank' policy advocated by the then Finance Minister Eiichi Baba in a May, 1936 speech (Hoshi 1995: 295). Banks were to be made responsible for creating an effective conduit that would allow the government to allocate funds preferentially. It was simply more efficient (fewer transaction costs attached) to monitor a limited number of large banks. Being now increasingly dependent on government channelled loans, banks accordingly were more eager to comply with government directives. Risk caused by uncertain and limited information dissipated. Banks, as a result, were relieved of any worry concerning financial failure. This was in stark contrast to the period between 1920-1932 when on average 44 banks per year went under. Starting with the Temporary Funds Adjustment Law of 1937, through to the Total National Mobilization Law of 1938, the Corporate Profit Distribution and Fund-Raising Order of 1939 and culminating in the Bank Funds Application Order of 1940, the government was able to seize practical control of all bank lending. Banks subsequently faced no pressing need to evaluate the risk attendant on any given loan. Firms that produced what the government needed for the war effort simply received a required level of funding. The planned purchase of wartime output guaranteed repayment. Risk shifted to the government, which also insured the financial viability of the system as a whole. Banks formed lending consortia to share any remaining risk and to co-ordinate lending policies.

The Munition Companies Designated Financial Institutions System (1944) completed this process by assigning a designated bank to serve a particular munitions company. A bank distinguished in this manner would become the lead bank of a lending consortium. Many of these same wartime main bank links continued into the postwar period, again with the main bank in effect taking the leading role in forming syndicates to lend to Japan's reviving industry. Inherent in this system was a reduced level of competition for loans and an equal chance for any given bank to share in loan issues, as they arose, by being part of some low risk lending consortium. Discernible in such arrangements were incipient versions of what would become an operative convoy system. A limited number of banks shared out banking gains and each bank insured that other banks avoided financial ruin.

Under wartime financial conditions, banks became the vital funding conduits for firms at the same time as they were largely stripped of any compelling need to exercise judgement on loans, essentially removing the need to assess risk. Firms in turn were emasculated by a continued dependence on bank loans to fund operations (equity having been deliberately transformed into an unattractive option). In this way, the control of the corporate sector shifted from shareholders to the government, as did the attendant risk.

The wartime system removed the ostensible corporate owners, the shareholders, from exercising any degree of control or functioning as monitors. Though the family owned conglomerates, the *zaibatsu,* still superficially collaborated in the war time effort, control had shifted away from these explicit owners even prior to the ostensible post war break up of this corporate structure. As mentioned, prior to the 1930s, funds were mostly internally generated or supplemented by selling shares to corporate affiliates. Bank lending never exceeded 20 per cent for most of the major *zaibatsu*. With shareowners firmly in control, monitoring within the *zaibatsu* was largely the responsibility of a number of designated directors under the guidance of the *zaibatsu honsha* (the holding company). This group acted as an auditing committee, capable of vetoing or delaying projects, as well as reviewing any current investment.

But, maintaining prime responsibility to shareholders could produce a potential conflict of objectives if firms sought to respond to the profit demands of shareholders as well as the expansionary imperatives of a war-time government, as a proclamation of that era (1938) indicates.

> The majority of shareholders take profits by selling appreciated stocks, sell in times when the price is expected to fall, and often seek dividend increases without doing anything to deserve them. If these shareholders control the directors of companies, influence strategies, and seize a substantial amount of profits, then the system of joint stock corporations has serious flaws (Suzuki quote in Hoshi 1995: 306).

The solution was to make shareholders effectively superfluous by allowing them to retain the appearance (*tatemae*) of control rather than the reality (*honne*). Government controlled bank lending now provided the funding needed to support significant expansion in the heavy industrial sector. Dividends were highly restricted as well. The 1939 Corporate Profits Distribution and Fund-Raising Order capped the dividend pay-out ratio at 10 per cent. Shareholders became largely indistinguishable from bondholders since they now received a nominally fixed level of dividends. The risk inherent in holding equity vanished to a degree. At the same time, shareholders property rights dissipated, reduced to the passive position of receiving an assured, but small, percentage of any residual income. This policy of *antei haito seisaku* (stable dividends policy) continued without abatement in the post-war era.

Lacking effective monitoring or control, it is pointless to claim that the traditional family owners of the *zaibatsu* still defined its corporate governance. As mentioned, the official dissolution of this dominant corporate form during the post-war occupation only confirmed a wartime reality, governance had become a collaboration between management, banks and government bureaucrats. Personal relationships, built up over years of cooperation and facilitating an uninterrupted exchange of reliable information, dominated. Banks played an essential role, acting as the key intermediary between government and firms, a proto-typical agent that funnelled loans and monitored corporate operations. They neither evaluated the risk of loans nor chose the recipients of their loans. The demise of the war time regime left banks, at least at one level, ostensibly independent, even though in practise constrained by unofficial administrative guidance. They remained attached, for all practical purposes, to a particular set of firms or *keiretsu* (the transformed *zaibatsu*) to which the banks in turn provided the bulk of their loans. Through this reconstituted convoy system, implicitly backed by the Ministry of Finance, corporate loans and risk once more achieved only a nodding relationship. In the post-war period, the financial system continued to have risk minimisation as its basis.

## III. The Neo-Mercantilists

> Institutions appeared to (the mercantilists) then to be everything, the free play of individuals to be but little. It is the business of the rulers to prevent there being too many producers or too few, to resist polypoly and monopoly (Schmoller quoted in Marshall 1923: 721).

This new post-war period was not merely a recapitulation of its immediate past. The traditional security provided by a low risk existence could no longer assure the requisite majority allegiance. Occupation by US forces had opened up public debate to dissenting voices. The promised domination of an all-inclusive middle class, what Murakami would later refer to as the New Middle Mass (1982), offered the Japanese an additional decisive element. Keeping Schumpeter's (1950) prophetic work firmly in mind, we might say that post war Japan sought to preserve traditional economic interests (small farmers, small business, family retailers) by indirectly subsidising the incomes of each group. The sting of market competition would be effectively drawn. By implicitly taxing the leading sectors of the economy, the government could substantially maintain the economic viability of all groups simply by extrapolating the logic of the financial convoy system. As with the banks, an increasing level of cash flow became essential if the entire convoy was not to sink. Inevitably, a growing number of weak sectors threatened to swamp healthy ones. Would-be economic policy architects faced three particularly troubling hurdles:

- How to accomplish such results outside of a wartime economy which effectively eliminated demand uncertainty.
- How to cement such a system given the seemingly initial hostility of the occupation forces to traditional business interests.
- How to ensure the victory of these entrenched business interests over the newly invigorated labour unions.

Defusing the uncertainty of demand translated into an expedient use of neo-mercantilist techniques. Market competition would not be left to fend for itself but would be guided. For mercantilists, economic coordination required conscious central planning. Only governments could prevent market forces from riding roughshod over weaker constituencies. Harmony within the kingdom needed guidance, competition needed to be channelled.

This position was not unique to Japan. In the immediate post-war period, the simultaneous sharp memory of the recent depression and the fear of an imminent one largely outweighed any niggling worries about government intervention. Prices were deliberately distorted at both a micro and macro level to accomplish economic objectives. Ostensibly all planning, whether via the National Economic Development Council in Britain or MITI in Japan existed to promote economic growth without giving too much consideration to issues of economic efficiency. Growth, however, was only of secondary importance to planning proponents. Of prime significance was social stability given the current state of many war-ravaged economies (especially Japan and Germany), and the cruel memories of the thirties when dire economic conditions sparked open defiance and rebellion.[7] The communist alternative, especially via the perceived Trojan horse of union movements, provided a serious threat to traditional, market-driven capitalism.

Government intervention insured that economic and social tensions did not boil over. Growth would help but not growth at all costs. In Japan, rapid growth gained importance only insofar as it facilitated the establishment of an all-inclusive middle class society and allowed risk to be either reduced or shifted to the public realm. In the first two decades of 'miracle' expansion, the idea of catching up with the western economies served to promote a collective mentality. As was the case for the industrialisation surrounding the Meiji Restoration, it also promoted social stability by focusing on national goals and away from individual, or more narrowly defined class, concerns. Efficiency was of only secondary importance at best, in fact a prime candidate to be sacrificed if such choices had to be made. There is no sense in worrying about how best to employ scarce resources if, as you believe, resources are likely to be idle as the result of deficient aggregate demand. As mentioned before, politicians were more interested in results. A neo-mercantilist program that sought to limit competition could, given the right circumstances, gain broad support.

The post-war Japanese policy makers did not seem overly impressed by formal economic theory.

> They argued that Japan, as a country with little land, few natural resources, and a large population, obviously had to have an industrial policy, or similarly, that to catch up with the industrialized nations or to improve the international competitiveness of domestic industry required industrial policy (Komiya 1988: 5).

Japan faced a massive job of repairing a ruined and defeated country. US occupation forces, by initially insisting on a radical change in Japanese economic and social structures, inadvertently promoted distinct levels of seemingly destructive turmoil. Japanese workers became the most strike-prone and least productive of any industrialised nation in the immediate post-war era. This fundamentally hindered an industry policy which targeted those sectors expected to produce and to promote a sustained growth spurt. But growth was essential only insofar as it sustained the over riding objective of rebuilding social stability. Though growth was needed to underpin stability, growth without a prior degree of stability was not possible. Subsequent Japanese industrial policies that appeared to inhibit growth were not necessarily simple mistakes. They often existed deliberately, at least in part, to minimise social frictions.

Social stability explicitly required an industrial policy focused on job creation for a rapidly expanding population. Perhaps more importantly and much more implicitly, the same policy sought to preserve those jobs once created. Achieving these dual objectives meant not only targeting assumed high growth areas but also managing the contraction of declining industries to minimise any economic dislocations, especially job loss.

To those bureaucrats charged with these responsibilities, this would seem obvious. Neither Adam Smith, nor a principled attachment to market competition, ever held much allure. Market competition, to the bureaucratic mind, was all too likely to squander scarce resources. But attempts to channel competition, while simultaneously encouraging investment and expansion, would retrospectively create a persistent serial problem of overcapacity in a number of domestic industries. The policy reality (*honne*) became a series of ad hoc solutions despite determined attempts to maintain the appearance (*tatamae*) of deliberate planning. Because of this split between rhetoric and results, most of this period's policy relied on using deliberately vague terminology (like excessive or wasteful competition) which while lacking an exact meaning, retained an exact purpose.

In many ways, the Japanese were following an older and to them a more intuitive approach which emphasised the need to explicitly cooperate to facilitate coordination. They would have taken to heart Schumpeter's (1935) description of the damage done by the gusts of creative destruction or would find equal sense in Marshall's (1923) prescriptive words concerning cooperation. Given this view, markets required guidance from above, a joint collaboration of business and government, if risk was to be controlled and growth promoted. In contrast, the full force of market competition was likely to disrupt social patterns, exactly what was not wanted in a time when Japanese decision-makers were intent on restoring social stability as the basis for economic growth. The desired form for reconstructing the economy was a continuation of, rather than a break from, traditional Japanese patterns. What emerged was an economy where government performed the role of an information facilitator, specifically encouraging the flow of information between key players, rather than providing any means of public accountability. This acquired role became an effective instrument for reducing investment and operational risk.

Given such objectives, Japanese officials judged that the most pressing need consisted of catching up to the leading industrial countries by targeting fast growth industries (those with high factor productivities, whose products had a high income elasticity of demand, or which were linked to products having such characteristics). The formula had seemingly been successfully tested during the Meiji restoration. Implicitly they followed the appreciative literature on technological catch up, rather than the more formal growth theory of the time.

We need to look more closely at how the Japanese, or essentially the same group of Japanese that had commanded the country and the economy for decades, managed to subvert the aims of the American Occupation Forces while simultaneously establishing a concordant between business and labour. When we in fact conduct a careful examination of these pivotal developments, there is certainly nothing predestined about post-war Japanese institutional evolution. In that sense, Noguchi (1998) is correct. Those

Japanese struggling to re-establish a version of the 1940s system could not foresee or precipitate the developing geo-political reality of the post-war era. It took a particular set of circumstances to insure their success. Certainly the Korean War or the deepening Cold War, which rescued a faltering economy, was not something these Japanese politicians, bureaucrats, and businessmen factored into their strategic gambits. But they were undoubtedly successful at seizing the moment when opportunity came knocking. What is not surprising is that there would be a given set of pre-war businessmen seeking to use government structures to re-establish a favourable status quo. These objectives could best be accomplished by first co-opting the most reliable elements of the 1940s system, and then aligning them with certain existing political and bureaucratic interests who harboured similar goals. The revived structures would appeal to traditional collective motivations. The one clear change was to at least dampen if not entirely eliminate a defined hierarchy of wealth, while establishing and shoring up a well-defined hierarchical structure based on alternative measures. To work, the 1940s system had to be made much more inclusive.

## IV. Post-war Struggles – The Phoenix Economy

> MacArthur had no use for the special privilege that the prewar Japan had afforded the zaibatsu, the huge, interconnected industrial complexes that had dominated the nation and were believed to have helped push Japan into the war. He said that the zaibatsu, in which government and giant industries were intertwined, represented "private socialism". He believed that the society had to be changed and that political democratization by itself was not sufficient. Without introducing economic change as well, the Americans would be creating a fertile field for a radical new order. Political change had to be accompanied by economic change – especially the redistribution of land from the large landowners to poor tenant farmers ... He also wanted to limit the power of the zaibatsu and give greater economic power to the average worker (Halberstam 1986: 115).

As previously pointed out, the immediate post-war period in Japan had an unfortunate resemblance to the instability that had characterised the twenties. To many influential Japanese, repeating and reimposing many of the same solutions (without a corresponding military flavour) seemed eminently reasonable. However, the American occupation forces, under General MacArthur, initially focused on transforming Japan into an idealised version of 'New Deal' America. In the battle between corporatist elements wanting to retain a perceived status quo of power, if not wealth, and those elements desiring either liberal reform, or the application of leftish ideologies, 1945-

1947 represented the high-water mark for the forces of change. Shigeru Yoshida, the dominant conservative politician of this critical period 1946-1953, was prominent in fighting a rear guard battle against New Deal reformers surrounding MacArthur. His legacy was the Liberal Democratic Party (often identified as being none of those three things) a political coalition which would form one of the bulwarks of the 'Iron Triangle'. This subset of business, administrative, and political leaders would manage Japan successfully though out the post-war period.[8] The key battles in what became an extended campaign to establish dominance, all involved transforming American reform initiatives into policies that achieved conservative business objectives. Japan would adopt the appearance (*tatemae*) of western liberal democracy as a vehicle to promote traditional feudal structures in which risk was minimised and collectivised. To do so, conservative business leaders would willingly pay the associated price, by promoting an all-inclusive middle class society. They would, in practice, buy off potential opponents. The main focus of battle would revolve around four inter-related aspects of the post war economy:

- establishing a working agreement with labour,
- land redistribution,
- corporate business structure,
- financial institutions.

## A. Labour

The first and most pitched battle arose over labour. The turning point came on February 1, 1947 when MacArthur refused to allow a potentially crippling General Strike to go forward. This clearly marked a change in the US approach to the reconstruction of Japan. The Cold War was intensifying. MacArthur, who harboured hopes of running as the Republican presidential candidate, seemed to take his subsequent cues from the results of the 1946 Congressional elections which saw a definite swing to conservative Republican candidates. Out went the New Dealers, in came the political and fiscal conservatives. Then, following the fall of China to communist forces, Japanese unions in 1949 were purged of communist members. An estimated ten thousand workers lost their jobs and many times that number were dissuaded from joining.

The Cold War marked a significant shift in labour relations away from western-style confrontation. The immediate postwar era in Japan changed from one of rolling strikes and radical unions, to a collective or consensus agreement in which enterprise unions accepted security (low risk) in return for delivering a dependable rising level of productivity (at least in a selective group of manufacturing industries). The decisive moment or turning point, which served to define the eventual dominant form of labour relations, occurred in 1953. The Nissan strike, beginning on May 25th, lasted until the end of that year. It saw management smash the existing, radical union let by Tetsuo Masuda and replace it with an in-house union, essentially a creation of management. The strike reflected two events that would have far reaching consequences for the Japanese economy.

One was the arrival of Joseph Dodge in Japan on February 1, 1949. Dodge came with the expressed aim of reshaping the direction of the Japanese economy. This became exigent since, given the emerging Cold War, Japan was slated to become a reliable US ally if not a US surrogate in the Pacific.[9] In a brief three months tour of duty, Dodge laid a foundation that allowed traditional Japanese business interests to re-emerge. His insistence on conservative economic policies (balanced budget, low inflation, low exchange rate) would provide the incentive for setting up an economic system that kept the appearance of the imposed western style system while undermining the reality through a program of clever risk sharing and income redistribution. But it did have the immediate effect of squeezing credit and causing businesses either to fail or to drastically cut costs by laying off sizeable numbers of workers. This was the wedge employers needed to reestablish workplace discipline.

The Korean War was the other great event of that time. Like some *deus ex machina* in a Greek tragedy, the sudden surge of demand, which the war created, rescued the Japanese economy. Producing parts and vehicles for the US army would financially float firms, like Nissan. While preserving companies, such as Nissan, which had been on the brink of concluding their business histories, success stemming from war production only roused fractious workers, resentful of subsequent layoffs generated by the 'Dodge line'.

Nissan's success in driving a wedge between its workers by imposing a second union (*chiro shioji* or house union), reflected, in embryo, many of the features which would come to characterise Japan's low risk economy. The Industrial Bank of Japan (IBJ) and the Fuji Bank provided loans to see Nissan through the strike (especially, desperately needed funds for its suppliers who were otherwise incapable of surviving a sustained strike). This role, quite naturally, evolved out of the main bank structure installed during the wartime years. In the credit constrained post war years, the main bank's continuing role of directing capital flows, provided these banks with a critical degree of leverage over its largely *keiretsu* borrowers. As lead lender, a main bank could reassure other lenders by overseeing the corporate borrower directly, when necessary. The director of Nissan during these key years, Katsuji Kawamata, had originally been seconded from the IBJ, Nissan's main bank. Assured funds noticeably reduced the risk of taking on such a confrontational union. Putative business rivals provided explicit support by agreeing not to take advantage of Nissan's vulnerable position. The *Nikkeiren* (employer's association) arranged for its suppliers to receive temporary work from other manufacturers.

Enterprise unions, once established, guaranteed rising wages and promoted job security. In return they delivered a dedicated workforce given to shunning western style confrontation. The era when labour strife characterised the economy ended with the failure of the Nissan strike. Future labour relations changed dramatically. In the ten-year period (1988-1997) virtually no working days would be lost through strike action. Amongst the 23 OECD nations, only Switzerland produced a similar aversion to adversarial labour relations. The majority of OECD nations lost an annual average of over 100 days per 1,000 employees during this same period (OECD data 1999). Labour relations would sustain and promote the underlying objective of assuring a middle class existence to employees. In exchange, employers won a distinct reduction in the risk that traditionally accompanies a standard labour contract.

Extending this same consistent theme of risk reduction, remuneration came to take the form of a salary augmented by a bonus payment. The bonus itself could equal up to four months' pay in value. This arrangement underwrote the creation of a low risk, middle class society in two ways. It reduced the commitment level of corporate employers. If bonus payments are not considered as part of permanent income (or at least relatively more transient than the permanent portion) then it is far easier to squeeze wage bills in the course of an economic downturn. This ability to shift some of the costs of cash flow problems meant that Japanese firms faced less pressure to adjust costs through layoffs. Reducing wages by adjusting bonuses, rather than the sort of quantity adjustments favoured in the West, could dominate. (In Japan's worst post-war downturn in the nineties, this strategy clearly has been operative.) In a second sense, remuneration via large bonus payments induced greater saving. At least in the early post-war decades, most, if not all, of any bonus payment awarded would be saved. Funds, no matter where deposited, were effectively rechannelled to the relevant main banks. This helped to create a collective pool large enough to float rapid investment. Bank loans, rather than equity placements, could continue to dominate corporate strategy as they had since the thirties.

The appearance of a consensus, rather than inherent confrontation, would continue to prevail during these post war decades. In essence, the Nissan strike proved to be a significant developmental watershed in post war Japan. *Nemiwashi* (behind-the-scenes consensus building) would be-

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come standard practice.[10] Before any action could be taken, issues were talked to death. By establishing a collective contractual responsibility for any and all outcomes, the cherished pretence created was that the ostensible managers and directors of a corporation were not dictating but merely responding to the articulated views of their employees. With everyone signing on to agreements, responsibility was effectively shared. No one was individually responsible, making it a lower risk option to eventually support such a consensus derived decision than if all responsibility had resided with a particular individual or group. Given the lack of specific responsibility, fewer resources needed to be expended in insuring against individually assumed risk. There were at least two negative aspects to such risk allocation. The consequence of failure need not lead to any radical, or even a significant, management overhaul. Collective risk through widespread agreements implied that while incremental and even continual adjustments and changes were easily achievable, radical departures would not so easily be accomplished. (The larger the change, the less likely no real losers would emerge.)

Implicitly this meant falling back on a family or quasi-feudal governance system dominated by mutual obligations, where personal rather than strictly bureaucratic or even market driven relationships were the norm. Loyalty to a given *zaibatsu* for instance ('I'm a Mitsubishi man') was common even prior to the war. This sense of loyalty and obligation if anything intensified after the war and after the breaking of radical union power. Corporate employers deliberately fostered it. Perhaps, to some degree, this was only a displacement of the traditional loyalty to the Emperor. Or it may simply have been the most effective way to socialise a vast influx of workers pouring in from rural Japan. (The rural population went from nearly 50% immediately after the war to less than 5% today.) These workers were trained by the company, slept in company dormitories, and spent their spare time in company recreational facilities. This instilled loyalty had quite a rational basis. For the approximately one-third of the population, working for the largest corporations, the opportunity cost of losing one's position was prohibitively high. Tacit agreement amongst the large corporate employers (the *keiretsu*) meant re-employment in a similar position was unlikely. Instead, a substantial drop in income and prestige was the inevitable result. For a capital poor country devastated by the Second World War, creating the appropriate institutional structure that would best utilise its only abundant resource (labour) was essential. Much of Japan's subsequent success depended upon a highly productive labour force willing to make necessary adjustments in work practices (including rapid automation). The bargain struck in the aftermath of the Nissan strike, low risk employment coupled with rising incomes in exchange for hard work and assured trust can be seen

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as a model of all such post-war arrangements.

Though ostensibly the American occupation forces under MacArthur were there to reshape Japanese society and economy, the reality, as is often the case, turned out to be otherwise. The occupation forces left behind them numerous American inspired rules, regulations and institutions all of which were subtly customised to meet Japanese objectives or at least the objectives of an influential subset of the Japanese. This could be expeditiously accomplished since explicit rules and regulations count for less than the way in which they are executed, especially in a society where personal rather than bureaucratic relations dominate. Reforms then can best be understood as contributing to, rather than conflicting with, this post-war vision of a low risk, middle class society.

## B. Land

The same inseparable duality that marks appearance and reality for the Japanese determined the course of any other ostensibly imposed change by the occupation forces. Land reform would seem to be the most American inspired and successful of the occupation demands in the sense of staying closest to its objective without becoming captured by war-time Japanese institutions and used to serve those alternative purposes. This however would be a particularly naive or a deliberately superficial analysis of the actual devolvement of post-war land reform. The fact that the very conservative politician and sometime Prime Minister Shigeru Yoshida made only a token objection to the implementation of this plan, perhaps gives the game away.

The stated objective was an end to the era of the large absentee landowners, rightly thought to be the backbone support of Japanese militarism. Redistributing land to the existing small tenants was meant to accomplish this goal. The reality was:

- agricultural output needed to be expanded to feed a rapidly rising population now that Japan had been stripped of former overseas colonies such as Korea or Taiwan;
- redistribution of land meant redistribution of income away from the traditional land holding classes whose wealth then dissipated when the real value of their reimbursement dwindled due to a raging post-war inflation;
- redistribution of income raised the underlying level of aggregate demand in the economy with farmers being the first to edge their way into the level of prosperous middle income life;

- the system of small holdings which had characterised pre-war Japan was conducive to part-time farming (through *dekasegi* work – temporary employment away from the farm) representing the reality of existing farm families;
- the agricultural sector became the hard core support for the emerging Liberal Democratic Party, as it had for the increasingly militaristic governments of the thirties and forties.

Agricultural reform had the very desirable side effect of reducing wealth and income differentials since, as stated, payments to former land owners quickly evaporated in a flurry of postwar inflation. What was added to the wartime economic framework was a realisation that for an economic structure in post-war Japan to be viable, the mass of the population had to be coopted. Constrained from appealing to traditional strains of Japanese nationalism (particularly those tainted with an expected military hue), any compelling approach would have to elicit familiar clan-like obligations, although here the clan was enlarged to one's workplace and through that linked to the nation as a whole. If individual Japanese weren't subjected to distinct class differences which could divide members of an indivisible Japanese clan, then such an appeal could be effective in creating what Murakami (1982) refers to as the New Middle Mass, an all-inclusive class society. By not having any explicit ideals or ideology to constrain it, the LDP could focus on cultivating this ever enlarging, broad-based Middle Class society. The LDP continued to operate at the level of village politics. It was merely a matter of shifting a portion of the distributed rewards to the emerging urban base without seriously harming its traditional conservative support (the almost feudal constituencies of the rural areas and the self-interested business class as well).

The Japanese government of the day was willing to see the traditional moneyed classes reduced in stature to achieve the stability of a rising and ever enlarging middle class in Japan. In return for their support, the dominant Liberal Democratic Party would provide the agricultural sector (as well as small retailers and other such groups) with security in the form of redistributed income. Seeking to avoid the market trap stipulated by Schumpeter, successive Japanese governments under the Liberal Democratic Party extended such redistributive aid and security to additional urban groups as their original rural support shrunk due to urban migration.[11] The LDP has been more successful at making the transition from being a traditional conservative party to one which is clearly more of a 'catch-all' party than any of its European counterparts. Lacking a well-defined set of policies or any noticeable ideological edge made this continuing transformation all the easier for the LDP.

## C. Capital

The LDP evolved into one of the most flexible of Japanese institutions. Since it firmly holds no strongly grounded beliefs, there are accordingly very small costs in changing direction. The LDP has made few specific ideological investments over the years. Instead, the party's *raison d'etre* has been the distribution of spoils to its constituents. It was a relatively easy matter to increase the number of relevant constituencies by a strategic redistribution of government revenue, only continued economic growth was needed. If growth faltered, other alternatives would prove in the long run to be inimical to these middle class aspirations. Deficit financing has its intrinsic limits and increased taxation contradicted the underlying LDP aim; to distribute benefits to constituencies from a growing pot, not to remove them via higher taxes. Still, at this juncture in its post-war institutional evolution, one might question the ability of any political party to provide continued low-risk protected existence for inefficient sectors if that continued protection rested almost entirely upon sustained economic growth.

In return for this desired protection, the LDP garnered votes and monetary contributions. The electoral system was so constructed that only a well-funded party could gain a sufficient number of seats. At the same time, small parties could survive and get their own slice of government handouts in the predictable political consensus building, analogous to the *nemiwashi* procedure previously described. Consensual agreement shifted legislative responsibility away from individuals or any specific group of legislators. (Only the Japanese Communist Party has consistently stood outside such benefit sharing arrangements.) The electoral system, in its implementation, proved to have an in-built level of stability. Only in 1993, when faced with internal dissension and desertion, did a ramshackle coalition of minor parties successfully challenge the LDP. It failed to provide even a degree of short term stability.

Given the inherent political economy of postwar Japan, though in American eyes the ordained attempt to break up the corporate *zaibatsu* may well have been a textbook implementation of anti-trust legislation, the reality inevitably would take quite another path. In many ways, the occupation forces considered such legislation to be the corporate counterpart of land reform, a simple matter of removing the other major support behind the Japanese military regime. This seemingly straightforward exercise tediously failed to proceed in an expeditious fashion and subsequently provoked resistance in the US congress from conservative Republican business interests. In effect, the legislation that was put in place aimed more at removing control of these corporate structures from their traditional corporate owners than in providing support for market competition. This objective largely reinforced and confirmed the institutional arrangements which had evolved during the war years. The stranglehold on the Japanese economy of a few wealthy families ended. Corporate management could shift funds away from relatively passive shareholders and into the hands of employees. Generating increasing levels of cashflow, rather than producing profits, dominated strategic objectives (though in a rapidly expanding economy one didn't preclude the other). The underlying imperative remained a continuing effort to minimise those standard market mechanisms that created clear winners and losers.

> In essence, the post-war financial system eliminated credit risk. Defaults by big companies were very rare, because their main bank would always bail them out. If the main bank did not have enough cash to do the job, then other banks would chip in. And if all else failed, the government, as the banking system's ultimate backer, would pick up the pieces (*The Economist,* June 28th 1997: 19).

Price competition would normally lead to temporary states of excess capacity, dissolved through a subsequent series of resulting price wars. Expansion, and especially the investment to achieve such expansion, was usually associated with a number of standard risks. Encouraging market competition would inevitably conflict with the underlying Japanese objective of promoting growth and economic well being by the effective reduction and reallocation of risk as well as an associated redistribution of economic gains. Starting as early as 1953, the Japanese resolved this apparent conflict by instituting an American style Anti-monopoly Act (part of the occupation reforms) but undermining its intent both de jure and de facto. Amendments proscribed its reach while lax enforcement undercut any remaining effectiveness. Regulation seemed to invite a 'don't tell and we won't ask' attitude on the part of Japanese bureaucrats. Any attempts by the Fair Trade Commission to prosecute, tended to be overruled by the Ministry of International Trade and Industry (MITI) which traditionally exercised more clout. Given the low risk of prosecution and relatively low penalties attached, cartels of the official and not so official variety defined the Japanese industrial sector. The number of such agreements alone meant that outsiders would remain uninformed about the effectiveness of this practise. It is unclear if even senior members of the LDP had a sufficient grasp of the pervasiveness of such arrangements. By the late sixties more than 1000 official cartels of one sort or another were operating.

The use of cartels and more generally the wide spread use of administrative guidance characterised a system of personal relations stressing cooperative decision making in contrast to the risk ridden dictates of market competition. The bureaucracy's importance and numbers grew as its influence spread. It was clearly in the interest of the existing bureaucracy to maintain and expand their reach. But it was just as much to the advantage of many of their corporate clients to foster such a system. The on going success of administrative guidance can be seen in the fact that it was largely welcomed rather than imposed. Personalised relations entrenched the key role played by the bureaucracy. With the rule of men rather than the rule of law dominating, Japanese style administrative guidance facilitated economic transactions. Given a lack of demonstrated economies of scale in such relations, a growing economy translated into an ever-expanding bureaucracy. Moreover, only in such an expanding economy could an increasing number of retiring bureaucrats secure a low risk middle class life by accepting a place in one of the corporations they previously had guided or in some non profit sector organisation set up to accommodate retired ministry 'old boys'.

Price fixing and assigned market share resolved any temporary disparity between supply and demand in the marketplace. Recessions simply meant that declining sales were shared according to existing market shares. Equally, capacity increases were constrained by market share as well. In the minds of the post war Japanese planners, price fixing cartels decreased the risk of what they scornfully referred to as wasteful competition. Given the limited capital available during these early years, recession and guidance cartels insured that there would not be a loss of the vital productive capacity needed to engage in international competition. Capacity increases were achieved more rapidly knowing that the effects of excess capacity would be cushioned. Japanese firms bounced back with greater ease from short-term recessions without any noticeable losses of jobs or notable bankruptcies. The construction of an equivalent industrial convoy system made sure that any pain would be spread around rather than falling on only a limited number of firms.

A system where the risk of any serious level of overcapacity becomes negligible, is one where the most pressing problem becomes maintaining and increasing the level of production. The risk of not meeting demand through a production stoppage becomes the over riding concern. This accounts for the type of employment system which evolved and which has previously been analysed. With growing capacity and sales a seniority system of secure jobs operated on the premise that the incoming cohort of relatively low paid young workers expanded faster than the existing levels of higher paid older workers. The further transformation of the disbanded *zaibatsu* into the less explicitly maintained *keiretsu* minimised the risk of opportunistic hold-ups without resorting to formal ownership (neatly avoiding the inherent problems associated with asset specific investments). In more general terms, the *keiretsu,* whether vertical or horizontal, was yet another aspect of Japanese industry policy that emphasised low risk and income redistribution. Gains and losses were rationally shared in return for lower individual risk. The sidelining of the stockholder, as a decisive constituent, meant that firms could ignore demands for consistently high profit performance during periods of economic difficulties. Lead banks focused on having corporate debt serviced, and other *keiretsu* partners looking to grow as well, all found increased cash flow to be mutually advantageous. As any economics textbook would assert, lower perceived risk led to greater investment, which generated the subsequent growth needed to float Japan's grand economic objective.

## D. Finance

The financial sector reflected many of the same objectives embodied in the *keiretsu* structure. Unlike other aspects of the Japanese post war economic system, the Cold War intervened before any serious attempt at US style reformation was made. (Only a token number of MOF bureaucrats were ever purged due to wartime activities.) Post war Japan alarmingly came to resemble the system developed in the thirties and forties. The financial sector to a large extent could lend apart from any mundane evaluations of risk. The entire corporate sector borrowed at approximately the same low rate (the range being exceptionally narrow). Banks funnelled funds to those firms in favour with the ruling bureaucracy. Resources were shifted in turn from regional banks to corporate lenders. Lending was more a function of rationing than of price. In the post war period, monetary policy was largely a matter of Window Guidance (WG) by the Bank of Japan (BOJ).

> WG policy had its origins in the early post-war period of strong and comprehensive economic controls ... In the highly segmented and regulated financial markets of the day, city banks found themselves with a limited deposit base and a strong demand by corporations for loanable funds. Controls on deposit rates and on branching restricted competition for deposits. Administratively determined lending rates and an underdeveloped securities market encouraged high levels of indirect finance. In this environment, city banks found themselves dependent on the BOJ and private banks for funds. With the BOJ's discount rate *always* below interbank and other lending rates, the city banks had a strong incentive to borrow from it. With a positive net return on BOJ borrowing and branch expansion, they also had a powerful incentive to comply with the guidance of the financial authorities (Rhodes and Yoshino 1999: 167).

This risk reduction strategy extended to all aspects of the Japanese post-war economy. The roots of such an approach were entangled with the events of thirties and forties when successive military governments stubbornly moved Japan away from becoming a more market-based economy. The transformation of objectives, officially instituted by the occupation forces, into structures more consistent with this very Japanese idea of a low risk, middle class society had, by the time those occupation troops departed, restored a high level of harmony between the disparate elements of Japan's economy. Constructed in a time of capital shortage, it aimed at creating pools of saving that could be transferred at low cost to a growing industrial sector. Growth created funds that could then be redistributed, in agreed upon ways, to a variety of constituencies. The key to this whole process was assured growth. Problems would inevitably arise if the post war capital shortage developed into a capital surplus with savings outpacing increases in investment. How to deal with this persistent problem, while taking hesitant steps toward becoming an increasingly open economy, created a rolling series of unintended consequences. These would eventually expand beyond the cautious abilities of the bureaucrats toiling away at the government ministries (especially the legally trained acolytes at the Ministry of Finance) to apply appropriate patches.

## E. Bureaucracy

Manufacturing became the designated engine of growth in post-war Japan and consequently the means to constructing a low-risk, middle class society. More than any other industrialised country, the Japanese resisted the almost automatic transition to a service or post-industrial society. Only a heavy industrial sector could be counted upon to bear the full brunt of economic growth. The list of competitive sectors remained very small (cars and car parts, industrial machinery and consumer electronics) while the number of inefficient or welfare industries steadily increased over the decades. Many of these industries fell even further behind as the decades passed (this says nothing about the ever more expensive service and agricultural sectors.)

The Japanese did not rely on a standard market mechanism that inevitably creates clear winners and losers. Politicians alone could not insure that the business sector would place implicit policy objectives above the more compelling demands of market competition. By themselves, detailed regulations would overly constrain the economy. Only an idiosyncratic bureaucracy could act as the glue, which held the Japanese system together and acted as a facilitator guaranteeing that all change would be channelled in accordance with basic societal objectives. Accordingly, discretion rather than rules became the dominant characteristic of the post war ruling bureaucratic elite, a group defined by their deliberate lack of accountability. The general public assumed that no such need existed since the public service mentality enshrined in all ministries and agencies equated service with incorruptible behaviour. Based on this assumption, an absence of explicit checks appeared reasonable. Without a compelling need to scrupulously monitor public-spirited officials, the resultant savings in oversight resources led to potentially more effective and efficient governance by these select officials. Given this presumption of trust, bureaucratic judgement provided an institutionalised element of flexibility by allowing all regulations and objectives to be achieved via administrative guidance.

The rule of men rather than the rule of law govern Japan. (This alone meant that though the occupation forces left Japan with numerous Americanised rules, regulations, and institutions; the actual implementation would subtly customise these western constraints so that they abetted Japanese objectives.) Japanese laws, as drafted, were left deliberately vague to allow bureaucrats to exercise authority in quite detailed ways. Such decisions were given orally without creating an official record. These decisions in turn were wrapped ambiguously enough to require additional interpretation. Administrative guidance in practise allowed corporations, or financial institutions, greater latitude of action. Yet this same ambiguity shifted risk away from the bureaucrats onto the business sector. Officials could decide after the fact, and only in light of actual events, if the relevant institutions acted correctly. Under such a system, tolerance for cutting corners eventually spread. The relevant bureaucrats were not responsible if a problem occurred since permission was never directly given. In one sense, the risk attached to administrative guidance was shifted back on to the corporate sector, encouraging bureaucrats to make extensive use of this procedure. But given the small likelihood of detection and the even lower risk of enduring significant penalties, the actual risk borne by the corporate sector as a result of Japanese style regulation remained minimal.

To work, such a system must depend on a reliable flow of information between business and bureaucrats. The creation of an 'old boy' system established an informational network of former chiefs spread strategically throughout the economy. Rewarding a bureaucrat upon retirement via the *amakudari* (descent from heaven) process supplied sufficiently appropriate incentives to assure performance throughout thirty years of service.

In a contradictory way, the system was fuelled by growth, but the lubrication of growing wealth could serve simultaneously to corrupt the very bureaucrats that maintained the ongoing viability of the Japanese system. This was aggravated by an essential lack of accountability embedded in the idea of administrative guidance. Public service gave way to serving specific business interests and by doing so serving oneself.

This very generation of wealth was inevitably suppressed by those who were supposedly most interested in insuring its increase. Channelling competition and the subsequent outcomes of such competition meant an inherent allegiance to maintaining the status quo in Japan. Unanticipated and uncontrollable change must by definition be antipathetical to hierarchical groups of administrators. When the economic environment in which Japan operated changed, the response was to try to patch the existing institutional structure in such a way as to continue to deliver a Japan where an all-inclusive middle class lived in an assured, low risk society. In other words, the changes made in the long run exacerbated the problem by failing to address more fundamental issues. Rather, the perceived need to maintain the status quo of entrenched advantages tended to dominate other, perhaps more important, objectives. The inevitable distortions would undercut the ability of the economy to generate the required levels of growth.

## V. Cursing the Winners and the Winner's Curse

> Those who flourish are destined to fall into decline (Former President and Founder of Honda Motor Corporation, Sochiro Honda, quoted in Sakiya 1982: 130).

The economic system and its attendant institutional structure hammered out in the immediate post-war years of reconstruction stood up effectively for a good two decades, providing the basis for consistent double digit growth and the transformation of Japan into the world's second largest economy. In the early seventies, with the generation that forged the concordant between the different elements of Japanese society ageing, two economic shocks demonstrated that this arrangement, like any other institutional structure, was specific to a particular economic environment. For those who were closely observant, the first fissures in the Japanese economic machine would have been apparent already. That they should appear at this stage is somewhat ironic, since Japan would emerge from each one of these shocks seemingly stronger than ever before, increasingly creating the image of Japanese invincibility. This illusion would gather strength throughout the decades of the seventies and eighties. Stopgaps, and in retrospect, merely temporary devices to shore up an increasingly fragile economy, achieved in the eyes of an admiring, or frightened, world wide audience the force of an irresistible juggernaut. One is tempted to say that while the *tatemae* of the Japanese economy seemed to be one in which the secrets of economic management had been unlocked, the *honne* was that of an overextended economy, out of sync with a rapidly changing environment, and increasingly geared to a high level of growth.

What Japan constructed was a prescription for a selectively closed economy, a very time specific approach. The challenge to maintain such a construct became increasingly difficult as members of the iron triangle attempted to fend off a series of shocks by defusing the risk that these shocks added to the economy. Unfortunately, in each resolution lay the ground for an even greater vulnerability to any subsequent shock. The ability to invariably deflect risk must inevitably fail. It was as if each time a fleet of invading 'black ships' was defeated and sent on their way, an even larger number returned to try again. At some point even the best defences must falter and the tide which swells economic growth must fade.

The building blocks of post-war Japanese society (and of its economy) simply became inconsistent with Japan's environment as it was forced to shift from a predominantly, inward looking, closed economy to a more open, international one. The reality of a mass middle class was fading just as most of the Japanese had convincingly bought into the belief. Notice the great success (Table 1 below) in the case of the farming sector. The generalised convoy system seemed to be working with a vengeance in rural confines.

**Table 1. Perceptions About Own Standard of Living**

| | 1965 (%) | 1971 (%) | 1977 (%) | Employed Persons 1977 (%) | Farmers 1977 (%) |
|---|---|---|---|---|---|
| Lower than average | 3.0 | 3.5 | 3.2 | 2.8 | 1.3 |
| Slightly lower than average | 17.8 | 16.5 | 14.6 | 13.8 | 9.9 |
| Average | 47.0 | 49.0 | 40.5 | 41.0 | 48.2 |
| Slightly higher than average | 27.0 | 27.1 | 36.1 | 37.2 | 36.0 |
| Above average | 5.3 | 3.2 | 5.5 | 5.2 | 4.6 |

Source: Ministry of Health and Welfare (1965-78)

The asset inflation of the late eighties would begin to fracture this consensus, subsequently aggravated by the prolonged catatonic economy of the nineties. In a society where the social safety net was largely privatised (a corporate responsibility) more of the population would automatically fall below the average standard of living if growth faltered and the employment machine ground to a halt. The basis for constructing an all inclusive, middle class society was guaranteed economic growth. Without that sustenance, the objective lost a good deal of its feasibility. The combination of asset inflation followed by stuttering growth brought a number of unwanted problems home to roost. For instance, policies that made land and housing into privileged assets were meant to encourage home ownership and farming in the immediate postwar period by lowering the risk of entering the market or equally important, of holding on to such assets. Favourable tax treatment in fact locked in home owners as land and housing became the most cost efficient way to pass on assets to younger generations.

The same lock-in effect dominated the farming sector to an even greater degree since subsidies and tax breaks were more pronounced in this sector. The implicit government undertaking that the convoy system would remain impregnably in place, removed a good deal of the risk of farming. But after the initial post-war years characterised by severe food shortages, Japan was saddled with an increasingly inefficient agricultural sector. Land reform had effectively deposed large landowners. But in an effort to prevent their re-emergence, the same reforms had made it unnecessarily difficult to farm on a large-scale basis, to rent land, or to have tenant farming no matter how advantageous. As a result, the Japanese consumer paid from six to seven times the world price for rice.

This pattern, of having consumers bear the hidden costs of such a society as well as whatever residual risk remained, created a producer bias in the economy. As wealth increased, this version of middle class life was bound to face dwindling support. In creating a low risk, middle class society in the post war years, choices had to be made not only regarding levels but distribution of risks. This often placed the Japanese government in a position of trying to resolve intrinsic irreconcilables. The solution was an expedient non-acknowledgment of the problem. Japanese manufacturers, as well as service providers, took domestic consumers for granted insofar as product liability was concerned. This bias meant the creation of a low risk environment, conducive for investment and production rather than consumption (witnessed by the delay until 1995 in instituting product liability statutes). As we have seen, the compelling necessity of creating the low risk, middle class society was assured growth. By reducing inherent production risks (and thus costs) through a combination of risk reduction and risk sharing, government sought to promote such an outcome.

Of at least equal importance, shifting risk from individuals and firms specifically assumed that government bureaucrats could more effectively deal with such risk at a national level. Yet there may not be the equivalent element of economies of scale when dealing with such risk. Certainly it may not be sufficient to offset the obvious moral hazard problems that arise if the opportunity cost of actions and decisions (in terms of risk) is significantly understated. In addition, aggregating risk in such a fashion may simply exponentially increase risk without a corresponding ability to deal with the levels that develop. Moreover, the lack of clear accountability, amplified by deliberately limiting the flow of information, creates, (especially amongst government bureaucrats who operate based on a policy of administrative guidance rather than regulation), the corresponding possibility of increased corruption. In fact those very characteristics which provided the backbone of the system, the *amakudari*/ 'old boy' structure, laid the seeds for personal aggrandisement and more concern for the well being of the institutions regulated than for the consequences to the economy as a whole. What we see repeatedly is that the structure and institutions (especially the informal ones) created to achieve societal and economic objectives became an expensive brake on required economic growth. The 'old boy' system is illustrative of this difficulty. An administratively guided economy encouraged top university graduates to enter the civil service. It created efficient back channels of information which allowed the rigid regulative structure to work via an environment of personal relations. The bureaucracy acted as a sort of shogunate to the official realm of the LDP. Given the vaguely defined regulations, risk could be assigned according to the appropriate bureaucrat's judgment.[12]

If we then think of the economic and organisational structures which defined Japanese society, it is clear that once assured rapid growth ceased, so did the effectiveness of the underlying system. The Japanese, through the agreement of its government, bureaucrats and businessmen, did make a series of changes throughout the seventies and eighties. Difficulties didn't flow from an unwillingness to change but from an inability of Japan's core objectives to evolve. The omnipresent bureaucracy still saw their function as ensuring sufficient growth to create the sort of low risk middle class society originally envisaged.

In the seventies, the end of the Breton Woods system underpinning the cheap yen, and the price shocks due to the first oil crisis, threatened essential economic growth just as the Japanese people were demanding the types of social benefits consistent with a middle class life. The Japanese government was pressed to expand government provided goods, health and welfare, while facing a more unpredictable economic environment. Unfortunately, sustained growth and high employment, given the continued high level of savings, could only reliably continue if an outlet could be found for this ever-increasing flow of Japanese production. The early seventies marked a shift in Japanese development to a policy of export led growth, what the Japanese aptly referred to as a "concentrated down pouring of exports" (*shūchū gōteki yushutsu)*. Up until this crucial moment, domestic and export growth had been fairly balanced.[13]

It takes no stretch of the imagination to see where the subsequent problems would lie with such a patchwork strategy. The urge to form cartels could only be tolerated if recessions were short lived and if recoveries were sharp and quick in nature. Cartels do tend to beget cartels (much as the woman who swallowed the fly needed increasingly more drastic solutions).[14] Protected industries felt no need to adjust to changing demand patterns but could almost reflexively expand without worrying about any associated risk. Subsequent downturns in demand would accordingly need further interventions.

Even had MITI desired to reverse this process, it would have found it difficult or even impossible to accomplish. MITI's own policy deliberately had created the problem by encouraging industry to expand. There was little, if any, pressure on firms to reduce capacity since businessmen and bureaucrats expected the temporary demand problem to be washed away in a new flood of growth. At each subsequent crisis, the tendency from all three components of the iron triangle would be to delay decisive action in the hope that growth would make such action unnecessary. In any case, such a reversal of policy would undermine the bureaucrats' authority and raise questions about their own necessity. One might question whether MITI in its incarnation subsequent to the period of post war rapid growth served any clear-cut purpose (other than sustaining an existing pattern of distribution). Moreover, a renewed effort by MITI to coordinate rationalisation and cartel formation did provide the Ministry with an on going justification when the decades of rapid growth ceased.

Subsequent events in the eighties can be understood in much the same way. In a continued attempt to eliminate the market game of producing winners and losers, the Japanese adopted policies that made it ever more dependent on sustained growth while ever less likely to achieve this aim. The Japanese system, built on personal relations rather than the accountability created by explicit checks, became individually ever more self-seeking. Corporations, grown rich in the post war decades, no longer relied as much on lead banks. Without that leverage, lead banks ceased to serve as any sort of effective check on corporate actions. Banks, lacking dependable corporate loans, sought outlets in booming asset speculations without in turn being checked by either shareholders or regulators. Perhaps more critically, this low risk approach had generated an inherently conservative approach by all key economic players (disguised as taking a long-run view rather than simply looking after one's own individual interest unchecked).

## VI. The Past as a Misleading Guide

> The Japanese may convince themselves of their moral and intellectual superiority, as the West once convinced itself of the same things, and consequently lose sight of the economic fundamentals that account for their success (Abegglen and Stalk 1982: 288).

The Japanese assumed that they had managed to create an economic system which successfully shifted risk from individuals to the collective community. The fundamental error behind this assumption confused the effects of unusually rapid growth with the economic system that reaped the benefits. Risk allocation largely becomes a curiosity, rather than a vital and vexing problem, in an economy swamped by growth. The long-term boom which characterised post-war Japan up until the first oil shock had as its basis two unforeseen but fortunate events (at least for Japan). Without first the Korean and then the Vietnam military escapades, Japanese growth would not have been as robust. The Japanese of course deserve credit for making the most out of fortuitous circumstances, but there was inevitably a price to pay. The economy that developed was geared to such favourable external shocks. (Even seemingly unfavourable shocks in the seventies had a positive edge. Oil shocks largely paved the way for Japanese car exports.) Compounding the problem, Japanese decision-makers convinced themselves that the virtue of their economic system was intrinsic rather than dependent. This must be a mistaken conclusion since efficiency remains defined by time and place. Unless the economic environment remains somewhat consistent or predictable, the ability to adapt effectively (quickly and at low cost) to changed circumstances may be impaired. The need to restructure is postponed in favour of past, successful solutions. The implicit promise to provide the Japanese with a low risk, middle class life became increasingly untenable. By denying rather than recognising the growing contradictions characterising their economic objections, the Japanese government, allied to a dominant subset of business interests, sought to put off the predictable day of reckoning rather than facing an increasingly intractable problem head on. As a strategic manoeuvre, this bought the economy a decade long stay of execution. Faced with the reality of the nineties, retrospective wisdom, as always, makes the underlying folly of the Japanese approach stand out in its starkness.

> Thought turns again and again into the accustomed track even if it has become unsuitable and the more suitable innovation in itself presents no particular difficulties. The very nature of fixed habits of thinking, their energy-saving function is founded upon the fact that they have become

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drag-chains when they have outlived their usefulness (Schumpeter 1961: 86).

## Notes

1 Collapse is of course a misnomer, though it does make for a more dramatic title. Since the end of its catch-up phase of post-war development, the Japanese economy has been undergoing a slow motion implosion. Starting with the early seventies, Japan has been wrestling with a chronic problem of insufficient domestic demand. The very institutions that aided its post-war development subsequently impeded further Japanese growth. A reluctance to sufficiently adapt to a changing economic environment eventually caused the Japanese economy to grind to a halt in the nineties.

2 This would include the criminal element as long as members worked through the approved *yakuza* channels. Crime would be regularised in a way that would make streets safe in return for a dependable cut of Japan's growing wealth.

> ... yakuza gangsters have replaced the old pre-war terrorist cliques; they prevent street crime, while their own organised crime goes largely unchecked, since often they operate in collusion with the police and politicians (Reading 1992: 230).

3 The English story of Dick Whittington's cat spoke to and represented the aspirations and burgeoning success of the rising middle class. In the US such stories became an institutional part of the national mythology. The young protagonists of Horatio Alger's books parallelled the real life stories of Carnegie, Rockefeller and others. These rags to riches figures differed from an older European tradition in that they needed no fairy godmothers or other forms of supernatural intervention. Theirs was a story of pure bootstrapping.

4 This is a key characteristic of the feudal governance system. Change generates uncertainty about the future and increases inherent risk. The feudal system aims less at generating economic growth and more towards finding a way of sharing existing economic wealth. A feudal system depends upon and emphasises social relations which best can be nurtured by the accretion of custom.

5 Saxonhouse has spent a lifetime denying that Japan forms a special case (see any of his voluminous writings especially Saxonhouse (1998) for a short update of these views.

6 See Hamada (1995) and Hoshi (1995) for useful treatments of many of these issues.

7 The priority of social stability shines through as the guiding principle of Beveridge's (1944) seminal work on full employment that became the touchstone for much of post-war British economic policy. The centralised planning and even nationalisation advocated in pursuit of this goal led his LSE colleague Hayek (1944) to write *The Road to Serfdom* in reply.

Much the same goal of social stability underlies *The Full Employment Act of 1946* in the US. While not supporting economic planning, Galbraith's (1957) book *American Capitalism* (originally published in 1952) emphatically characterises social stability as the prime public benefit derived from countervailing market power.

8 The 'Iron Triangle' is commonly considered to be the group of corporate leaders, politicians and government bureaucrats that informally decided the fate of

Japan through on going discussions. The long serving bureaucrats, the Japanese equivalent of the 'best and the brightest', has played a key role. Graduates of elite universities, these men formulated the policies that the LDP legislated and through informal administrative guidance attempted to regulate both economic and financial functions. The great bulk of the population remained largely out of the loop. The implicit contract forged in those post-war years with the general populace was an agreement that hard work, obedience and trust would be rewarded with economic prosperity.

9 See Okimoto (1998) for a broad ranging analysis of the Japan-America Security Alliance.

10 *Nemiwashi* contributed to the reluctance of Japanese firms to merge. In more recent decades, this helped to create a chronic problem of excess capacity, as a relatively large number of firms continued to compete for market-share. It is alleged that employees have resisted merging different corporate cultures. At the same time, the low risk nature of employment led Japanese workers to be highly receptive to automation. In 1986, Japan utilised 60% of the world's robots. Workers have formed a rather dominant constituency within the Japanese firm, far more important than shareholders. Koike (1984) refers to this approach as something akin to the white collarization of blue-collar workers. Others go further and characterise workers as the firm's dominant constituency. If worker job security and pay were the Japanese firm's principal objectives, this would explain the emphasis on expansion and cash flow. For this view of the Japanese firm as a quasi worker's collective, see Iwai (1995).

11 Success of such redistributive policies required the shifting of a substantial amount of resources to rapidly growing sectors. Without these sectors and an appreciably shrinking target to subsidize, the underlying logic of such redistributive approaches would break down.

12 Dore (1986) points out that the extreme rigidity of many Japanese institutions created the opportunity for flexible, unofficial practises.

13 Substantial as the deceleration of output growth rate has been in Japan, domestic growth has slowed even further. Throughout the 1950s and 1960s domestic growth has grew on average at the same pace as output. However beginning in the early 1970s, demand growth, began to fall short of output, a pattern that has become increasingly pronounced since the late 1970s. Indeed since 1979, Japan's domestic demand has, on average, lagged a full percentage point behind the pace of output growth. As a result of these developments, Japan's external payment (current account) surplus has widened dramatically to over 4 percent of GDP in 1986 (Kasman 1987: 46).

14 See Bronfenbrenner 1965 for an early examination of this particular cartel issue.

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