

Japan Needs the Theory of Reform

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It is unfortunate that there is no theory developed yet to back up the kind of reform urgently needed in Japan. Scholars are supposed to work on theories and education, but they are not doing their job in Japan.

The Lost Decade for Japan

It is often said with regret that the 1990s was a lost decade for Japan. Certainly, the average growth rate of Japan's GDP was only 1.6% during the 90s, less than half its growth rate of 3.8% for the preceding decade. Japan's productivity has fallen to the lowest level among the G7 nations, and Japanese banks and manufacturers have gone under and are being taken over by foreign ownership one after another. Japan's political leaders, often ridiculed and despised at home and overseas, are constantly engaging in factional alignment and strife. Citizens tend

to lose sanity and some commit homicide, even killing their family members. If you only looked at these dismal aspects, you could find no hope in Japan. There must be good reason for this hopelessness in Japan and we have to discuss this matter first.

I see two reasons. The first is Japan's long-term stagnation due to asset deflation stemming from the collapse of the "bubble economy" in 1990. The second reason is Japan's inability to adapt its political, economic and social systems to drastic changes in the global environment. These two seem to be reinforcing each other.

The delay in Japan's recovery from asset deflation is mainly due to the failure in economic policies. One factor is misjudgement of the seriousness of asset deflation and the necessity of effective policy measures. Those mistakes include premature fiscal tightening, spending sprees on ineffective public works, and adopting a low interest rate policy in desperation. We have to remember that every time those mistakes were made, serious concern and criticism was voiced by American and British scholars, governments and media. However, Japan kept on going without responding to those voices with persuasive arguments or theories, and failed eventually. The series of these events have resulted in serious downgrading of overseas evaluations of Japan's policymaking ability.

The second policy failure is the lack of decision making power. The most notable example is the treatment of bad loans. Managers at financial lending institutions have failed to adopt drastic measures. The government, while having realized that they had no choice but to inject a large amount of public funds, yielded under pressure from populist politicians and mass media, and consequently aggravated the situation by failing to persuade the public and delaying important decisions. Again regarding this problem, American and British financial authorities, based on their own experiences, tried to persuade Japanese policymakers and managers to solve the problem of bad loans by injecting a large amount of public funds, together with thorough investigation of management responsibility, but their advice was not accepted.

The Japanese-style Economic Model

The second reason for the lost decade is delay in adapting to global changes. Since adaptation means necessary changes in what used to be, we need to analyze what used to be in Japan.

There have been many studies in Japan as well as overseas on the structure and workings of the Japanese economy, because of its spectacular reconstruction and development during the post-war period. As a result, it has now been widely recognized that the Japanese economy has several characteristics that are not shared by the American and British economies. The main characteristics are as follows.

Politicians, bureaucrats, and business leaders are essentially interdependent and cooperative, and not antagonistic or adversarial. Of the three groups, bureaucrats' power is the strongest.

- (1) Bureaucratic administration is not strictly legally based, but discretionary, often using administrative guidance.
- (2) In large corporations, managers have outstanding power, and stockholders do not exercise their influence on management.
- (3) Within each industry and within each firm, such words as “cooperation” and “coexistence” are preferred to the word “competition.” A corporation-centered approach is dominant, as group solidarity and morale are supposed to be enhanced by avoiding frictions resulting from competition.
- (4) With a prolonged period of the cheap yen against the dollar, export-oriented industries have been regarded as the basis for economic development. Manufacturing tends to be emphasized much more than services or consumption.
- (5) Financial institutions, as a public sector, are under supervision and protection of the government, where the maintenance of financial order and stability is more important than management efficiency or customer benefits.

These characteristics were said to be formed for the purpose of mobilizing domestic resources to fight the war in the late 1930s, and also utilized for the same purpose to reconstruct the economy after the war. Despite the cold war, the post-war Japanese economy has been enjoying a

peaceful and stable environment in the world economy. In addition, Japan has in effect been “permitted” by other countries to maintain its closed domestic market in the long run. In this fortunate environment of its stable and closed market, the Japanese economy has been developing and utilizing its special characteristics to the fullest extent and realizing its miraculous economic development.

Two Principles in the New World

The special characteristics of the Japanese economy, however, have lost their effectiveness due to changes in the global environment since the 1980s. The most notable change was the end of the cold war as a result of the collapse of the Soviet Union. The victory of the West over the East has brought in two fundamental principles to unite the world, democracy and the market economy, which are supported by globalization tendencies in the movement of economic factors, and simultaneous technological progress in IT (information technology).

The important thing is how these two phenomena, globalization and IT, have impacted political and economic reality. The most notable effect of globalization on nations, firms and individuals is that the geographical area in which competition prevails is no longer limited to a particular region or a particular nation, but now enlarged to the whole world. A nation no longer can concentrate on domestic politics without regard for its international implications. Firms now face global competition as they buy, produce and sell globally, and as their customers’ choices are expanded globally. Even individuals must be aware of global competition, as their opportunities for education and employment become global in scope.

At the same time, spectacular progress in information technology, i.e., the so-called “IT revolution,” especially the proliferation of the Internet in the 90s, has had a wide-range impact on the fundamental functioning of the political, economic and social system. The greatest consequence of the IT revolution is information sharing among many people. It has made it possible for groups of voters, consumers, stockholders and employers to share the same information at the same time through advanced IT. In other words, the governance system based on

monopoly of information has collapsed. Consequently, “market tests” now have ultimate power. In this new environment, transparency and accountability are important requirements for the government as well as for firms. Satisfying these requirements will be absolutely necessary for acquiring credibility from many people who share sufficient information, i.e., from the market, and without it no one could survive international competition. The emergence of this new type of governance is the essence of globalization that swept the world in the final years of the 20th century. Severe global competition resulting from highly informed markets as the ultimate judge is bound to select winners and losers. By the end of the 20th century, U.S. and American firms turned out to be winners among nations and firms, respectively, and they became monopolists in the world economy, as a result of their successful adaptation to this new environment.

In the U.S., highly competitive markets emerged due to constant and consistent deregulation by the government since the 80s. Coincidentally, the era of IT technological progress arrived, as the quality of computers improved and Internet use became widespread. American firms entered the stage of severe competition to increase productivity by introducing IT into all aspects of management. Among others, IT is most easily tied to the financial service industry, where numbers are the main medium for business. In the U.S., financial institutions tried to win competition by applying IT to develop new products such as options and to make risk management more efficient. Financial engineering is a new academic discipline and has been developed almost exclusively in the U.S. Application of IT has affected each and every industry, and has led to the birth of new industries such as life science.

Winners and Losers

Corporate management has changed drastically as well. Management of financial assets has become extremely important, as pension funds and investment trust funds have increased due to the ageing population. Consequently, large institutional investors have increased stock investment and have more say in corporate management. Maximization of stockholders’ equity values has become the most important management objective, and those managers who

successfully achieve that objective will make a fortune, together with stockholders.

The rapidly expanding IT market has invited a large number of new entrants into the market. They are the kind of investors who are willing to take high risks for high yield expectations. New employment opportunities have created and absorbed those who were fired or laid off from existing industries. Managers have actively pursued mergers and acquisitions to strengthen their high yield sectors and acquire a higher market share, and stockholders have supported those moves. As a result, the power structure in each industry has almost completely changed. Thus, the U.S. economy has been expanding to an unprecedented extent in the last ten years, as fierce competition and IT innovation have been fueling each other.

However, just like the industrial revolution, the new economic order based on competition and IT, which originated in the U.S. and swept through the world in the late 20th century, has created winners and losers. Naturally, there seems to be an increasing number of people who see the negative aspects of the new world, such as relentless competition among firms and individuals, requirements for high levels of knowledge and techniques, money-centered lifestyle, extreme poverty as contrasted with brilliant successes, the collapse of the environment, ethics, and human relations, etc.

They include various kinds of people such as those who have lost their ability to compete and those who cannot overcome the so-called digital divide. Also there are those who deny and hate the new order. They all seem to share the feeling of protest against politicians, bureaucrats and managers who would not listen to losers' voices. As a result, there have been massive demonstrations against "leaders' plots" in various parts of the world, such as one against the WTO conference held in Seattle in November, 1999.

All these moves may be called part of the "anti-globalization movement," but it is not solely based on opposition to increasing unemployment due to trade liberalization. It is rather a vague but widespread movement to protest the new order, and is based on individual interests and, therefore, not unified for a consistent objective to lead to long-term benefits for human beings. An important characteristic of this modern protest movement is the use of the Internet as a powerful

tool. In the past protestors were isolated, but now they are able to mobilize a large number of sympathizers instantly on the Internet. Ironically, those who protest against the IT revolution are among the most skillful IT users.

It cannot be denied, however, that these protests are sensing the faults of the new order. The market economy and democracy have become sacred key words in the post cold war world, but they are yet to become a true “world order” with sufficient logical structure and concrete examples. While many of us can feel the basic merits and the associated problems of the market economy, our theoretical analysis and effort for improvements are just beginning. That is quite clear when we follow international discussions on the new order for international finance arising from the Asian financial crisis. Also it is undeniable that many nations in the world are gradually being democratized, but the election of a nation’s leader by a “free election” is not the necessary and sufficient condition for democracy, as we can see in the recent examples of East Asian countries and the U.S.

The new order that we thought the world had obtained in the last quarter of the 20th century is already showing some signs of tests and challenges at the beginning of the 21st century.

Japan’s Dilemma

Given these changes in the global environment, what kind of problems is Japan facing now? It has become clear that the main characteristics of Japan’s economic system, supporting its economic development since the 1930s, is no longer adaptable to changes in the environment beginning in the 1980s. Of course, Japan is not alone in this respect, as other East Asian countries share similar characteristics to those of Japan, and the U.S. and Europe are facing more or less similar problems. In the case of Japan, however, the degree of difficulty in dealing with the problem is much greater, because those characteristics have been supported by unprecedented successes in the past and have constituted the frame of mind for almost everyone, including politicians, managers, consumers, the media and scholars in Japan.

As has been mentioned already, the new world economic order is supported by such principles as competition, transparency, accountability, and self-responsibility. Nations, corporations, and individuals accept these principles as a prerequisite for survival and victory. The problem for Japan is the fact that agreeing to these principles would mean an almost complete turnaround, or an almost complete denial of the traditional Japanese principles.

The content of what most people refer to as “reform” is nothing but an incredibly wide-ranged, and therefore extremely difficult endeavor, and this should be recognized thoroughly. In fact, in the heartbreaking “lost decade,” almost every Japanese has become aware that something must change, but there is almost complete lack of recognition that changing that “something” would be a formidable task. The most notable is the reform of big business management. In management circles there are already (or still is) opposition to the new world order. Detractors cite such excuses as corporate social responsibility, stable employment and human orientation, the maintenance of social order, and even a fight against the American conspiracy. But quite frankly, most of this opposition stems from the inertia of past successes or the nostalgia for vested interests. The difficulties that Japan’s big business is facing are coming not from the fact that their management has transformed into the new order, but from the fact that it has not. Those big business managers who are opposing the transformation to the new order are not feeling the pain of reform but rather the fear to carry out the reform. What is needed is creative destruction. It should begin with destruction, because without it there will never be any creation.

Despite its bitter experience in the “lost decade,” Japan is delayed in transforming itself into the new order. This is partly because its transformation is a formidable task for Japan. But more fundamentally, Japan lacks the sense of crisis and also lacks logical thinking for the necessity and the purpose of reform, as it has failed to complete such processes as the solution of firms’ excess debts, excess equipment and excess employment, the write-off of banks’ bad loans, the consolidation and privatization of public corporations, the reform of budgetary planning, improvements in the education system, complete deregulation, etc. What should Japan

do from now on?

Theoretical System for Reform

The new world economic order is pressing Japan to almost completely transform values holding economic activities in the past. Such transformation could not be realized by changes in the public mood or by passive responses to market pressure. There must be a theoretical framework for proving the necessity and validity of reform. Otherwise, the effort to reform would become inconsistent and ineffective. Come to think of it, without exception there has been a theory to support reform in any country where its political, economic and social system was consciously reformed. In other words, excellent work in social science can predict, induce and clarify social changes, and can be done not only by scholars but also by politicians, managers, or bureaucrats, who sense and support those changes. In that way, the volume of reform movement will be increased and maintained.

Japan has failed to take the first step towards reform precisely because the aim and the content of reform are yet to be theoretically determined. The most notable example may be the field of corporate governance, where there remain many issues to be theoretically analyzed. According to the new economic order, the maximization of stockholders' value is said to be the objective of management. The typical objection to this thesis in Japan is that it would lose sight of long-term management perspectives and tend to disregard the benefit of employees. Those who advocate the maintenance of the seniority system and stable employment argue for the merits of company loyalty and intra-firm technological accumulation and against the new order of mobile labor markets and performance criteria.

Each of these problems is a real issue. However, Japanese managers do not have an answer to any of these problems beyond their hunches or feelings based on their successful experiences in the past. Although they know that the new order is gradually becoming dominant in the world and denying the traditional Japanese order, they are reluctant to transform the order completely or to accept that there is no choice but the complete defeat of Japanese firms. They wish to think

that there might be a “third way” for them, but they do not know or no one can tell them what it really is. Japan’s big business executives are not committed to reform, because they find no “theory of reform” anywhere in the first place.

The theory of reform is not a book itself. First it needs political leaders’ ideals as its foundations. President Reagan’s “belief in the market principle” or Prime Minister Ikeda’s “confidence in economic growth” provided such necessary foundations. Based on those foundations, good managers will speak by systematizing their experiences. Good bureaucrats will plan and execute the most effective policy measures to achieve given objectives. Most important of all may be the role of scholars, who should provide unshakable foundations for the necessity and validity of reform by theoretical analysis and empirical verification. Without it, there would be no backbone in a politician’s ideal, a manager’s experience, or a bureaucrat’s dedication.

Importance of Scholars’ Mission

It is quite unfortunate that there is no theory to back up reform in a country like Japan, which needs reform urgently. Political leaders are engaged in politicking, and unable to speak to voters about ideals and the system of reform. Quite a few managers are talking about management, but those talks are really about success formulas and maneuvers within their companies. Bureaucrats are completely “emasculated,” and would not mention that they are concerned about their country.

Scholars in social science are the worst. Their mission is research and education, but none of them are doing the job satisfactorily. Quite a few college professors are appearing in mass media as social critics or TV commentators, but none of them has ever made any internationally renowned contribution to an academic discipline in political, economic, or other social sciences. The fact that there is no Nobel Prize winner among Japanese economists is just one of those examples. While there used to be some “brains” who gave theoretical support to political leaders during the high economic growth era, there are none now. Without theoretical sup-

port, reform won't be successful. If we know the need for reform but do not want to yield to the new economic order completely and insist that there must be a third way for Japan, we must construct the third way by a theory, not by a hunch or by a feeling.

In the U.S. since the 1980s, young scholars have been competing in their research on various topics such as the effect of tax cuts on income, the relationship between inflation and unemployment, the effect of IT on productivity, risk management associated with financial globalization, etc., leading to the theoretical analysis of the new economy and the application of its analytical results in politics and management. It is obvious that we need wide-ranging research in Japan if we wish to find a third way. The kind of research we need for reform includes comprehensive analyses and case studies on the comparison among Japanese, American and European firms, the mechanism of decision making and information transmission, the behavioral mode of employees, the factors of corporate competitiveness, the effect of technological innovation, the effect of deregulation, the scenario of fiscal reform and its political, economic and social consequences, the adjustment of the structure of industries and the international balance of payments, exchange-rate policies, regional and international monetary policies, domestic monetary systems and policies, etc.

Business corporations and universities must initiate national projects for these studies right away. Corporations should spend money for this purpose as part of their social responsibility. College professors should go back to their campuses. Their job is nothing but research and education. The difference between scholars and social critics is such that the latter do not have accountability. In return, they will never be given the kind of honor that is offered to those who do their job with responsibility. Undoubtedly, education is one of the main pillars for Japan's reform. We need to touch on educational reform if we talk about the theory and research of economic reform.

There have been many explanations for less emphasis on logical thinking in the Japanese culture than in the western culture. It is undeniable now that the effect of education must have a strong influence, along with other factors such as religious, social, and structural differences.

In particular, the low level of research in social sciences seems to be a direct result of poor university education in this field. Regrettably, it is true that Japanese universities are of low quality by international standards. This is also confirmed by the fact that good scholars and students are leaving Japan for foreign, especially American, universities. Almost all the scholars who are doing respectable scholarly research in social science have once studied in the U.S., and many of the excellent scholars are remaining at their universities in the U.S.

Although there have been various discussions on university reform in Japan, not much change has been actually taking place at Japanese universities, as many of the junior professors admit. There may not be any other way to change Japanese universities, other than the liberalization of university education and the introduction of competition among faculty and students. This is a prerequisite for a successful economic reform. We must not forget the deep wounds and the valuable lessons that we have received from the “lost decade.” They are appealing to us that reform is absolutely necessary. Reform will not be brought about by hunches or feelings. We must construct a theory to support the necessity and validity of reform, and move forward with the theory as a weapon.

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