Economic Development Lecture

in Shanghai, China

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[Lecture Title]

Evolution of Development Paradigms and Socio-Economic Systems:
Global Changes/Imbalances & China's Path/Japan's Path

[Lecture Contents]

In this short presentation and discussion, I will present a quick overview of the evolution of the main economic development paradigms after WWII, and of socio-economic systems from before the Industrial Revolution. Globalization and the IT revolution should be properly situated in this development framework. Against this broad backdrop, I will then introduce the three pillars of poverty reduction, some of the key elements of the Japanese Development Model in transition, and challenges that we face today under the current global imbalances / changing global architecture. Where will China's path lead in the days and years ahead?

[About Speaker]

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Prior to his assignment at Nagoya University that started in 1996, he worked as an assistant professor at the Economics Department of Stanford University, an economic affairs officer at the Department of International Economic and Social Affairs of the United Nations (*UN Development Decades*), an economist at the International Economics Department of the World Bank (*Global Economic Prospects and the Developing Countries*). He served as a researcher at the Economic Research Institute of the Economic Planning Agency of Japan, a member in the Council of Economic Advisors to Japanese Prime Ministers, and as an advisor to the National Development Planning Agency of Indonesia (BAPPENAS). He also serves/served as a consultant to the World Bank, the Asian Development Bank, the African Development Bank, JICA/JBIC, and the Ministry of Foreign Affairs of the government of Japan.

In 1996, he published "China's Emergence: Prospects, Opportunities and Challenges," *Asian Economic Journal*, 3(10) (November 1996). His recent publications include *Leading Issues in Development with Globalization*, *Introduction to International Development Studies: An Interdisciplinary Approach*, and numerous journal articles/reports on global/regional economic integration, global crises, and on growth & poverty reduction. He holds a Ph.D. in Economics and Operations Research (Stanford University, USA).

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Outline of this Presentation (2nd slide)

In this short presentation and discussion,

(1) I will present a quick overview of the evolution of the main economic development paradigms after WWII, and of

(2) socio-economic systems from before the Industrial Revolution. Globalization and the IT revolution should be considered within the context of this development framework.

(3) I will then summarize three (3) pillars of poverty reduction, which are (i) economic growth, (ii) governance, and (iii) empowerment, and I will speak to their interrelatedness.

(4) Against this broad backdrop, I will introduce some of the elements of the Japanese Development Model in transition.

(5) At last, I will then introduce the key elements of the current global imbalances and discuss with you the path and the roles of China in the global economy.

1. Evolution of Development Paradigms

Let us start this lecture by reviewing the evolution of development paradigms after WWII. The evolution can be summarized by those key concepts in yellow-colored rectangles and arrows that show the shifts in mainstream thinking. Arrows in these slides also show increasing or decreasing importance of particular concepts in development as time goes on.

Key issues and topics that we will refer to during our discussion are shown in orange-colored ovals.

The evolution of development economics that underlies the evolution of development thought is shown in blue-colored ovals.

(After WWII – 1960s: Development Planning & ISI)
After WWII, countries resorted to ‘development planning’ and ‘import-substituting industrialization’ (ISI). With pervasive market failures and a small private sector, state-led development efforts were the primary characteristics of this era. Regardless of theories people subscribed to, whether they be of ‘balanced-’ or ‘unbalanced-growth’ schools of thought, ISI was the name of the game. After gaining political independence from colonial rulers, ISI represented a path to economic independence. Dependency theories supported the ISI thinking as well.

(1970s -: EOI)
While many countries with ISI strategies were confronted with stagnation in industrial development and widening current account deficits, emerging economies of East Asia (Japan, South Korea, Taiwan, Hong Kong, Singapore, etc.) had already shifted into an 'export-oriented industrialization' (EOI) strategy and recorded success in the 1960s. Observing this success, many developing nations then turned to the EOI strategy. (Africa lagged behind, in this regard.) Around this time, development economics started to utilize the theories of international trade (and international finance a bit later).

While a lack of visible 'trickle down' effects prompted the North (ILO 1972, WB) to call for more direct treatment of 'basic human needs', the South demanded a larger voice in the international community and obtained the New International Economic Order (NIEO) declaration in the UN (1974).

(1980s: SAP)
With the two energy crises in the 1970s and the debt crisis that erupted in 1982, 'stabilization' and the 'structural adjustment programs' (SAP) dominated the developing world in the 1980s. The resurgence of neo-classical economics supported these programs. Market-oriented development strategies with minimal state intervention were the dominating concept of the time. The motto moved from 'getting prices right', to 'getting policies right'. Development economics started to utilize theories of public finance and public sector economics.

(1990s: Good Governance)
With ongoing 'globalization' and the end of the 'cold war', the world witnessed the proliferation of 'neo-liberalism'. At the same time, with a review of the not-so-successful experiences with the SAPs, the role of governance came under closer scrutiny. Actually, according to a World Bank document *Governance and Development* (1992), it started with a statement made by an African reviewer of the World Bank report, *Sub-Saharan Africa: From Crisis to Sustainable Growth* (1989) in its draft review meeting.

> "Sound policy prescription itself does not produce economic growth or poverty reduction. It is good governance, consisting of strong leadership to carry out policies and capacity for sound development management, that produces the results on the ground. Africa lacks good governance."

The catchphrase became, 'Getting governance right.'

(Micro-NIE; Macro-Endogenous Growth Theory)
On the microeconomic front, theoretical support for governance arguments comes from New Institutional Economics (NIE). NIE asserts that:
1) Institutions define economic performance, and
2) Institutions can be analyzed by Microeconomics (of the incentive structure).

Started in the 1980s by the second-generation development economists, development microeconomics provided rigorous analyses for NIE. Analyses regarding imperfect and costly information, risks, and transaction costs were applied to topics such as sharecropping, microfinance, etc. This also led to the slogan, 'Making the most of local institutions'.

On the macroeconomic front, there were new (endogenous) growth theories that treated technology progress endogenously and stressed positive externality of ideas. These theories and investment in R&D pointed to the need for state coordination to avoid free riders and to promote joint investment activities. It followed that institutions of coordination on micro levels should be created by the state, as part of the state's role as coordinator of investment in knowledge/ideas.

(1990s: Human Development, Human Security)
The UNDP launched The Human Development Report (with Human Development Indicators) in 1990. With this annual publication, the development community started to pay more attention to 'human development', 'human security', 'entitlements' and 'empowerment'. The UNDP draws on the concepts of 'capabilities', 'entitlements', 'empowerment', and 'poverty as deprivation of freedom' from Amartya Sen and Paul Steeten.
The saying became, 'Empowerment of the poor.'

(late 1990s -: PRSP)
Partly from the exercises in self-examination brought about by the SAP experience, and partly aiming at strengthening governance on the part of developing countries, the Bretton Woods institutions started to transfer ownership of development to the developing countries themselves. The Poverty Reduction Strategy Paper (PRSP) is a documented strategy to be prepared by a developing country government, with the requirement of a social network mobilization (meaning participation of various agents/sectors of the society/economy).

(21st Century: New Political Economy of Development)
Going into the 21st century, we started to pay more attention to local culture, local institutions, local values. Yes, even amidst the ongoing process of globalization, or perhaps precisely *because* of this globalization, our efforts to make the most of local culture/institutions have become increasingly important. The 'new' in 'new political economy of development' represents these efforts.

The recent collapse of the U.S. financial model where the U.S. financial sector acted as a global financial intermediary with high leverage ratios, and the U.S. economy lived beyond its means for an extended period of time, thanks to the savings of other nations, signify a global shift in capital flows, and with it a shift in development finance. The world is moving away from this single-polar system (into a multi-polar system), as well as away from an arrogant version of neo-liberalism consisting of (free-)market-fundamentalism and democracy as seen in the U.S. society.

(Slide with **red-colored segments**)
With this global shift, countries—China and Japan alike—should revisit the development dialogue that we have had related to these red-colored segments of the evolution.

The markets will not give you the answer with regard to what kind of country/society you wish to build, or how to build it.

Both China at 60, and Japan after 64 years post-WWII, now face important questions regarding how we build a better country, and how we improve our citizens' well-being.

And with that question in mind underpinning the entire discussion today, we'll now talk about the selection of socio-economic systems that we have chosen and that we wish to choose in the future.

2. Revolutions and the Evolution of Economic Systems

Let us talk about the Revolutions and the Evolution of (Socio-)Economic Systems on a 2-dimensional map. In this map, the horizontal axis (X axis) shows the scale of organization. Moving westward, the organizations become larger-scaled; moving eastward, the organizations become smaller-scaled. The vertical axis (Y axis) shows the ownership of the means of production. To the north, private ownership. To the south, state ownership.

You can see prominent socio-economic systems on this map.
1st quadrant: Primitive Market Economy and IT-driven Market Economy
2nd quadrant: Capitalism
3rd quadrant: Socialism
4th quadrant: Utopian Socialism (or Pure Communism)

Let me provide some examples so you can get a better feel for this mapping.
1st quadrant: The US economy after the IT revolution, where the majority of households apply for tax credits on their business expenditures at home.
2nd quadrant: Imperialism, Monopoly Capitalism
3rd quadrant: The USSR after the Russian Revolution in 1917, Maoist China after 1949
4th quadrant: Linux, a free PC operating system developed & utilized by many internet users.
China has moved toward the north-east since then.
Japan's 1940-system built in preparation for WWII was situated just between the 2nd and 3rd quadrants. I will explain Japan's position later in Section 4.

Revolutions that have triggered the historic transformations in socio-economic systems are:
1) The Industrial Revolution in the 18th century, a move toward Capitalism, large-scale production;

2) Socialist Revolution (The USSR 1917, China 1949, African economies after WWII, etc.); and
3) The IT Revolution (1990s on), a move toward operations organized on a smaller scale, with solid networks.

If we superimpose the stages of development on this map, it looks like the following:
1) We started in the 1st quadrant as a Primitive Economy.
2) Many developing countries were then colonized under Colonialism (late 18th C. on).
3) Many became independent after WWII and resorted to State Socialism and Development Planning.
4) Since the 1980s and onward, particularly after the collapse of the Berlin wall, many transformed into Market-Oriented Economies or Transitional Economies.

One notable feature stands out in this map. Although the informal sectors of developing countries have been left out of this evolution and have remained in the 1st quadrant, the economic system has once again been approaching this quadrant after having moved though the 2nd and 3rd quadrants. This migration of the economic system back to the 1st quadrant is attributable to effects of the IT revolution. The IT revolution has the potential to formalize activities in the informal sector, or at least put them on the production/service network.

Japan, having started its post-war development process from where it was situated with its 1940-system, is currently in search of larger-scale operations in traditional manufacturing sectors (steel, chemical, electrical appliances, food, pharmaceuticals, etc.), and concurrently in search of smaller-scale operations in innovation-oriented SMEs. Environmental technologies would be the key in Japan as we are one of the world’s most energy-efficient producers. The electric car, by greatly simplifying production processes (without internal-combustion engines), opens the door for smaller-scale-organization oriented operations.

As the 3-time Pulitzer prize winner Thomas L. Friedman pointed out in his book *The Lexus and the Olive Tree: Understanding Globalization* (1999), ’Globalization’, like the polar star, is the system that provides coordinates for our activities on the ground. How can we capture the effects/directional forces of Globalization on our system map? On one side, Globalization points to a move toward the north as it has been private capital/investment-driven. In terms of the sizes of the organizations, multi-national corporations (MNCs) will get larger and larger in order to stay competitive in the oligopolistic global markets. In terms of the sizes of operations, global outsourcing, production networks, and ICT service networks point to activities by smaller-sized organizations with strong networks.

On the other side, Globalization underscores the need for state coordination. In order to foster the well-being of its citizens amidst the globally competitive activities of private corporations, the state should provide economic (incl. ICT) infrastructure, develop globally-competitive human capital, and protect the environment. The state should also develop and maintain a social network both at the national and community levels and provide a social safety net for its citizens to protect their well-being in this age of mega-competition. The state in developing countries should also design and implement policies suitable for their development needs, for example, (limited) protection of domestic industries under WTO rules.

Under Globalization and the IT revolution, governance matters even more. To be sure, quality of the state matters.

3. Three Pillars of Poverty Reduction

Let me now briefly turn to the pillar strategies for poverty reduction. I recently co-edited a book entitled, *Introduction to International Development Studies: An Interdisciplinary Approach* with Prof. Kimura and Prof. Ito, a development sociologist.

In this book, we define 'development' as the reform of the whole structural system that produces material as well as non-material poverty.

When 'proper incentives to get out of poverty' so defined by a development economist are given to the 'structural poor', if they are equipped with 'capabilities' and 'adaptability' to respond, those who cannot easily benefit from 'trickle-down' may rise to their feet and overcome poverty by themselves. The 'potential poor', who may easily fall into poverty given external economic/social/natural shocks, are equipped with resilience supported by social capital including social safety nets; they may not have to fall into poverty repeatedly. The poor have to be treated as active participants in their own development. Toward that end, people have to be 'empowered'. The target state of 'development' should be the situation where people are empowered, and a country is full of empowered human beings. 'International development' should be the international collaboration heading for this end.

Therefore, we set the three pillars of poverty reduction as follows:
1) Attainment of 'pro-poor' growth (the growth engine has to be running),
2) Adoption of proper public policies, incl. exercising good governance and building institutions of coordination with the stakeholders of development, and
3) Empowerment of the 'structural poor' and the 'potential poor'.

I have composed this lecture based on this way of thinking.

4. Japanese Development Model and Challenges It Faces

Now, let me share with you some key aspects of the post-war development of the Japanese economy. On this topic, a full 73-page Powerpoint note, "Post-war Development of the Japanese Economy —Development, Japanese/Asian Style—" can be downloaded from our program website (the URL is shown on the slide). This is a note that I prepared for students and policy makers in order to do the following:

1) to introduce the *macroeconomic* development process of the postwar Japanese economy (the so-called "Miracle Recovery");
2) to explore the Japan-specific (mostly *microeconomic*) elements of the market system that supported her rapid development;
3) to show the need for adjustments in the 'Japanese-style market system' in the post-catch-up era; and
4) to demonstrate the evolution and revolutions in economic systems underlying the development process. (Refer to Section 2 of this lecture.)

This note draws on 12 of the most prominent books on the Japanese development experience, dozens of working papers, and data reports from the Economic Planning Agency (now a part of the Cabinet Office) of the Japanese government, where I served as an advisor/visiting researcher. I hope it will serve as a public good here in China, too.

<u>In this section, although I have provided a rather detailed memo in this lecture script, I will go by the Powerpoint slides given the time constraints. For those who are interested in a detailed account of the Japanese development process, please refer to the following lecture note and/or the full Note on the web.</u>

1) Macroeconomic Development Process for a Miracle Recovery

(Devastation during WWII)
Japan was devastated during World War II (1941-45). The human loss mounted to 1.85 million (about 4% of the entire population) and 680 thousand injured or missing. The material loss mounted to about 25% of national wealth excluding military stock. Another estimate of the death toll was 2.8 million. Industrial production dropped just after the war to one-tenth of the pre-war level. An increase in budgetary expenditure such as veterans' payment and compensation for the war damage, together with a commodity shortage, caused hyper-inflation.

(Phases of the Postwar Japanese Development)
Post-war Japanese development can be divided into three phases, i.e.,
Phase I: Postwar Reconstruction and Catch-up,
Phase II: Era of Transition and the 'Bubble Economy', and
Phase III Lost Decade and Beyond.

Phase I of the economic development after WWII was from 1945 through the 1960s. A common purpose shared by business, household and the government sectors was to catch up with North American and European industrial economies. The collective and concerted actions coordinated by the government, often competition-restrictive, were effective in achieving this goal. A major obstacle on the macroeconomic front was the shortage of savings. The government created a system to mobilize and direct funds to key industries for rapid economic development. On a microeconomic front, the so-called 'Japanese-style market system ' was established, which emphasized building long-running relationships between economic agents. Stable relationships were built on a foundation including (1) the long-term employment system, (2) corporate governance built on cross-share holdings among businesses and with other financial institutions, and (3) the main-bank system. And together with active public policies/guidance, they played an important role in Japan's 'catching up' with industrialized economies.

In phase II (early 1970s—late 1980s), the Japanese economy caught up with other industrial economies in the world. The clear, common goal had been achieved. Japanese business and household sectors should have changed their behavior from the one based on collective actions to the more autonomous one of coping with their own risks under a more competitive environment. However, we failed to change upon the celebrated success with our old system. Collective business practices and government interventions largely remained. With a lack of innovative investment opportunities and poor corporate governance, business firms and financial institutions rushed into speculation in financial and real estate markets, creating the 'bubble' economy. Expansive macroeconomic policies adopted in order to cope with yen's rapid appreciation in the middle of the 1980s also served to fuel the speculative bubble. Then, the 'bubble' burst in the face of restrictive monetary policies, first in the stock market in 1990, and then in the property market in 1991.

In phase III (the 1990s and on), the Japanese economy struggled with the aftermath of the burst 'bubble'. Excessive investment, excessive employment, and excessive lending and over-borrowing that had piled up during the bubble development period had resulted in excess capacity and mounting non-performing loans. The necessary stock adjustment of this 'excess', however, has been delayed in consideration of job security. This delay in adjustment resulted in long-lasting stagnation, persistent deflation, and financial crises, in spite of massive expansion of government expenditures and the money supply. This, in turn, created a public domestic debt overhang. In order for the Japanese economy to get out of this trap, a comprehensive strategy and bold structural reforms are indispensable. The Japanese economy is in the middle of a multi-pronged fight to (1) stop deflation, (2) reform the public sector and its budget, (3) resolve problems associated with non-performing loans and stabilize the financial system (mostly done), and (4) to stimulate business sector confidence through regulatory reforms, tax reforms, and a conducive environment for technology development. The Japanese society, facing a rapid aging of its now-declining population, is now also confronted with reform needs in its social security system.

(Postwar Reforms-**Democratization** of the Economy)
The allied force (General Headquarters = GHQ) first tried to democratize Japan on both political and economic fronts. The GHQ believed that a concentration of economic

power in a limited number of companies, financial institutions and landlords' hands, coupled with the lack of democratic forces such as labor unions, had been the hotbed of militarism in prewar Japan. Thus, the so-called 'economic democratization' reforms were carried out first.

1) *Zaibatsu* dissolution (1945): Z*aibatsu* were big conglomerates of major companies and banks, often controlled by a share-holding company. The most powerful ones were *Mitsui*, *Mitsubishi*, *Sumitomo*, and *Yasuda*. To eliminate concentration of economic power, *zaibatsu* were dissolved and share holding companies were prohibited. (Fair Trade Law and the Economic Power Excessive Concentration Elimination Law was enacted in 1947. Liberalized in 1997, 50 years later!)
2) Fair market rules (1947): American-style market rules were imported. The most important laws were the Anti-trust Law and the Securities Exchange Law, enacted in order to secure market competition and transparency.
3) Agricultural reform (1945): The government purchased land from absentee landlords and all the tenant land in excess of one hectare, and sold them to tenant farmers at nominal prices. The percentage of tenant land dropped from 46% to10%. The number of Independent farmers increased. **Land tenure security** was established early on.
4) Labor market reform (1945): Through an enactment of the Labour Union Law (1945), Labour Relations Adjustment Law, and Labour Standards Law (1947), the organization of labor unions was promoted and their labor movements were legalized.
5) Education reform (1947): The compulsory education was extended from 6 to 9 years.

(Fund Shortage and Increased Role of Banking (indirect finance))

During the reconstruction phase of the postwar Japanese development, the biggest macroeconomic challenge was a shortage of funds for investment or <u>a shortage of savings</u>. In the early 1950s, the household saving rate was around 10% according to the System of National Account (SNA) data. The figure was slightly higher in household surveys (than in employee households). Like many other developing economies, Japan faced the risk of falling into the "savings shortage trap" where a shortage of savings leads to a shortage of industrial funds, which in turn leads to a limited production capacity, to stagnant income, and finally comes back to aggravate the savings shortage.
In order to cope with this shortage, Japanese government adopted targeted policies and directed funds to key industries for dynamic economic growth, rather than relying on a market-oriented allocation of the limited funds.

First, the government relied on financial intermediary institutions to supply industrial funds, rather than relying on capital markets. To this end, three big long-term credit banks were established (along with large commercial banks) in order to provide long-term credit to these key industrial sectors. (Main-bank System)

Second, the government introduced the fiscal investment and loan program (FILP) in order to channel public funds to key industries through newly established public financial institutions such as the Japan Development Bank and small business loan corporations. The major sources of funds were postal savings.

Third, the Bank of Japan (BOJ) supplied high-powered money to the private sector by providing loans to private financial institutions through 'window guidance'. Commercial banks borrowed money from the BOJ and actively lent to business sectors, resulting in low capital ratios ('over-lending'). Business sectors borrowed heavily from financial institutions, again resulting in low capital ratios ('over-borrowing').

Then, the social system was formed/geared for increased savings: long working days, a six-day work week, and poor social security provision.

The role of corporate retained earnings was large, too.

(Growth without **Inflation**)
This type of monetary expansion could normally lead to rapid inflation. However in Japan, overall inflationary pressure did not emerge. This was the case as the long-term credits provided were immediately used for real business investment, leading to an expansion of production capacity in a very short period.

'Over-lending', or a persistently low capital adequacy ratio, ought to increase bankruptcy risks of financial institutions. However, the government policy protected the banking sector from bankruptcy and from cut-throat competition. Banks that faced financial difficulty were merged with healthier banks before their collapse. This policy scheme was often labeled as a 'convoy system', with the Ministry of Finance acting as commander-in-chief. As such, from the 1950s to the early 1990s, no major bankruptcies in the banking sector occurred in the Japanese economy.

(Artificially Low Interest Rates and Concentration of Funds)
Interest rates were controlled at levels lower than potential market rates (open financial markets were underdeveloped). The 'Extraordinary' Interest Rate Control Law, enacted in 1948 to control increases in interest rates during the post-war hyper-inflation, survived 40 years and kept deposit and loan rates at low levels. Together with this interest rate regulation, the official discount rate (the rate of BOJ loans to commercial banks) was also kept at a lower level.

Artificially low interest rates amidst a shortage of savings naturally bring about excess demand for loans, that in turn calls for credit rationing. 'Window guidance' was adopted to compel commercial banks to provide funds to key industrial sectors, and to restrict an extension of the loan supply when monetary policy had to be tightened.

The only liberalized financial market was the inter-bank 'call loan' market where financial institutions dealt short-term money with each other in order to cover temporary shortages of funds. The 'call' rate was regularly higher than the official discount rate, and therefore regional banks and other small-size financial institutions had incentives to provide their surplus deposit to the call market rather than supplying loans to local and small businesses at less favorable terms.

(Balanced Budget until Japan Joined the OECD in 1964)
The hyper-inflation after the war was partly attributable to the Japanese government's

massive budget deficit and its direct financing by the BOJ. In order to control inflation and to prepare for a self-reliant economic reconstruction, the 1947 Budget Law prohibited the issuance of bonds to finance the current deficit—the so-called 'deficit financing (covering) bonds'. Initially, there were loopholes in budgeting due to the existence of special accounts. Since the FY1949 budget, Japan's national budget was balanced on a consolidated basis (that is, including special accounts). Until the first half of 1960s, the budget was kept neutral to the macroeconomy.

Therefore, for two decades of the Miracle Recovery, monetary policies were the main leverage to propel development.

The recession in 1965 turned out to be the first post-war economic slump against which monetary loosening was not effective. A serious question was raised regarding whether the post-war rapid growth process driven by business investment had ended. Pessimistic views predicted persistent shortages of final demand unless it was supported by government demand. In 1965, due to a shortage of tax revenue, the government was forced to issue deficit financing bonds, enacting an extraordinary law to allow it. Since then, in order to fill gaps in final demand while conforming to the Budget Law, the Japanese government has continued to issue bonds under the name of 'construction bonds', to finance development of social overhead capital. The size of bond financing (deficit financing by bonds) continued to be small until the mid-1970s.

(Economic Plans)
To what extent did the government's economic plans contribute to the success in Japan's post-war development? The Japanese government first adopted the 'Economic Self-Reliance Five-Year Plan' in 1955. Then economic plans of five- to ten-year duration were created in sequence. The 'Doubling National Income Plan' adopted in 1960 with the target year of 1970 was often regarded as the most successful plan. The plan that aimed at doubling national income in real terms in ten years was executed successfully by building confidence within Japanese business and household sectors, thereby attaining such rapid economic growth. Even before the enactment of the first official plan, there were discussions among government sections, businesses, consumers and academia that contributed to the national consensus building on development strategies.

(Nature of Economic Plans in a Market Economy)
Economic plans in the market economy were geared to communicate government's views on the future of Japanese economy to the public, and to form a **national consensus**. Japanese economic plans usually consisted of the following ingredients: i) medium-term development scenario that the government assumes, including an economic framework such as targeted rates of economic growth and inflation; ii) medium-run economic policy goals and policy priority, including allocation of investments in social overhead capital in the plan period; and iii) private sector's actions that the government considered desirable. As such, these plans were of an **'indicative-type'** rather than those of **'command-type'** widely seen in central planning economies. Acceptance of those suggested actions was optional rather than compulsory.

(Market Opening during the 1960s)
During the 1950s, as Japanese exports increased, industrialized countries gradually stepped up the pressure on the Japanese government to open its market. In the 1960s, the Japanese government initiated the process of **market opening in a strategic (scheduled, step-by-step) manner**.

Trade liberalization was conducted by changing the foreign currency quota for the import of restricted commodities (FA, fund allocation) to an automatic approval (AA). In 1960 the government adopted a comprehensive plan to liberalize foreign trade that changed a ground rule from 'restriction as a rule, openness as an exception' to the contrary. The ratio of liberalized import lines rose from 34% in 1959 to 93% in 1966. With regard to foreign exchange transactions, the yen regained convertibility in 1960. In 1964, Japan accepted the IMF Code Article 8 that ruled out foreign exchange restrictions for the purpose of balance of payments stability.

As to capital flows, the law on foreign capital of 1950 stipulated that inward FDI should be allowed only if it contributed to an improvement in balance of payments. In reality, the majority of inward FDI applications were not approved as they were perceived to bear risks of harming the Japanese business sector. In 1967, a basic program for capital liberalization was adopted. This program was implemented by 1970, again in a step-by-step manner. By 1970, majority foreign ownership was allowed in 80% of Japanese industries.

(Changing Comparative Advantage)
As wages went up in the Japanese labor market, labor-intensive manufacturing products such as textile products gradually lost their price competitiveness. On the other hand, price increases in capital-intensive and technology-intensive products were mostly avoided as wage increases in these sectors were largely offset by healthy productivity gains. Their prices relative to those of foreign products showed a declining trend, thanks in part to yen's fixed exchange rate. Thus, the structure of comparative advantage in Japanese manufacturing sector had completely shifted. Capital- and technology-intensive products were also products that faced elastic demand (high income elasticity). As a result, the structure of Japanese exports changed dramatically.
Given this rapid shift in comparative advantage, industries such as textiles, coal mining, shipbuilding, and after the first oil crisis, aluminum, exited or slimmed down substantially. Positive adjustments were made in expanding industries. The chemicals industry, originally concentrated on production of fertilizers, shifted its focus to basic chemicals, and then to 'fine' chemicals. Cement and other related industries moved to production of synthetic materials such as 'fine' ceramics. Textile industries turned themselves into multinational fashion industries.

(**Export as an Engine for Growth?**)
Looking at the developments in GDP components, exports or external demand had not necessarily played a major role quantitatively in Japan's economic growth, at least until the first half of the 1960s. On the macro front, business investment had been the major engine for Japan's growth. The contribution of export expansion– 'trade (export) as an engine for growth' – was made through its **microeconomic effects** instead, by

stimulating innovation and productivity growth in Japan's manufacturing sector.

2) Microeconomic Elements – Elements of the Japanese Development System

(Elements of Japanese-Style Market System)
In the development of Japanese industries, certain institutional schemes and business practices played an important role. Typical elements of the Japanese-style economic system and business practices included long-term employment and related labor market practices, such as in-house training, the dominant role played by the banking sector in corporate finance (via direct financing), corporate governance controlled by managers supported by a main-bank system, cross share-holdings among companies, and a close relationship between government and business with regulations and other kinds of market intervention such as 'guidance'.

(Origins for the System)
These elements of Japanese-style market system are often believed to be deep-rooted in Japan's traditional culture. Others think that this framework was designed after WWII for a quick recovery from the devastation of the war. In fact, many of the elements of the Japanese economic system originated from just before WWII, when there were national mobilization policies in preparation for the war (the '1940 system'). The system survived the war and was built into the Japanese economy with substantial adjustments after the war.

(System with Long-Term Relationships)
Whether the 'Japanese-style' market economy was a rational system or not continues to be debated. It was characterized by its *long-term* nature. That is, it included stable long-term engagements of economic agents, often implicit both in intra- and inter-company relations. Some elements of the system were exclusively Japanese, while other aspects were commonly shared with other market economies.

Although the long-term relationships embedded in the Japanese-style market system contributed positively to her economic development, it was exclusionary (anti-competitive) in its nature. New and potential entrants to markets, particularly foreign businesses (and foreign governments), continue to criticize this exclusivity.

(Cross Share-Holdings)
A separation of ownership and management of corporate entities was originally established in the United States. Japan, too, had separation of management from ownership, but in a Japanese style. A large portion of corporate equities was (and still is) held by other corporate firms including financial institutions, often known as '*stable* shareholders'. This took the form of '*cross share-holding*' among firms. Those (cross) shareholders were believed to be *stable owners* as they do not usually sell off the shares, try to take over the firms, or intervene in the management.

Cross holdings of corporate shares originated after WWII, partly as a substitute for pre-war *Zaibatsu* conglomerates that were forcefully dissolved, and partly as a preventive measure against M&As by foreign multinationals.

Thanks to this common practice, Japanese businesses had been relatively free from the threats of adversarial takeovers and from interventions by shareholders. In addition, as the stable corporate shareholders did not usually request high dividend payouts, the capital cost of equity finance had been extremely low. As such, corporate profits were mostly re-invested in new equipment, and this in turn raised the value of the firms and created massive capital gains for these shareholders.

This tendency toward low dividends was formed during WWII, when high dividends to capital investment were deemed inappropriate (Noguchi,1995). In 1939, dividend regulation was introduced. When inward foreign direct investment was liberalized in the 1960s, this system was effectively utilized in order to protect Japanese firms from takeover bids by foreign multinationals.
Thanks to this practice of stable shareholdings, corporate managers had the luxury of pursuing their long-term goals. As the mandate of management was not dominated by short-term profits, Japanese firms were able to invest in equipment, research and development, and human resource development.

The downside was the possible moral hazard in management as managers were not subject to monitoring by participants in capital markets.

(Main-Bank System)
The Japanese corporate sector relied heavily on loans extended by financial institutions. Even today, when corporate financing through the capital market (i.e., direct financing) is growing, a substantial portion of business debt stock is still in the form of bank loans (i.e., indirect finance). (77.5% in 1997)

Most firms have their *main banks*. A main bank for a firm is defined as the bank that has the largest share in total bank loans extended to that firm. Moreover, main banks often arrange bond and equity finance for the firms, and regularly monitor their corporate management and business plans/projects.

(Functions of Main Banks)
From a microeconomic point of view, the regular collection of borrowers' information by main banks was good therapy for the problem of information asymmetry between lenders and borrowers (i.e., the 'monitoring' function of main banks). This saved the cost of information collection and the risks associated with lending for non-main banks. In case management performance of a borrower firm temporarily worsened and the risk of bankruptcy arose, its main bank was expected to step in and rescue the firm with contingent loans and/or a loan rescheduling. A main bank dispatched top managers and extended advice for its rehabilitation (the 'insurance' function). When a decision was made by a main bank to finance a firm's project(s), other banks were pleased to provide additional loans as the main bank guaranteed the profitability of the project(s). In case of difficulties, the main bank was expected to assume the burden of a corporate bailout (the 'signaling' function). The main-bank system had played a role of corporate governance in the Japanese post-war system of development. In post-war Japan, where

shareholders and capital markets did not assume the monitoring role due to the existence of 'stable shareholders' created by cross share-holdings, main banks took that role.

(Equity Financing to Bank Financing under the 'Convoy System')
As a matter of fact, before World War II, corporate firms relied more on capital markets for their financing of investment. Commercial banks then often lacked the capacity to evaluate borrowers' repayment capabilities and associated risks. As the war became imminent, the government tried to provide a larger portion of available funds to military-related industries by seeking more direct control over fund flows. The authorities denounced stock markets for their speculative and disorderly nature, and encouraged markets of financial intermediation by banks. The authorities believed that financial intermediation by banks was much more controllable. Therefore, the seed of the main-bank system was formed in WWII, when the Japanese government took steps to make banks the key financiers of the economy. In 1942, examination departments were introduced into commercial banks by government regulation and began their regular monitoring of borrowers. This scheme was thought to be the origin of the main-bank system established after the war.

The main-bank system facilitated Japan's economic growth by allocating funds to growing industries. Tight regulation of the financial sector by the Ministry of Finance, or the so-called 'convoy system', kept this sector 'orderly' and preserved a stable main-bank scheme. The main-bank scheme helped businesses to develop long-term plans by regularly providing loans and serving as a lender-of-last-resort in case of financial difficulties. Thus, the main-bank scheme played an important role in Japan's corporate governance as it kept corporate management prudent and long-term oriented.

The <u>downside</u> was that this scheme unavoidably weakened competition among financial institutions in terms of their fighting for corporate customers/borrowers. Main banks also often influenced borrowers' finance decisions and hindered the sound development of capital markets in Japan.

(Japanese-Style Employment Practices)
The Japanese labor market had been characterized by its so-called 'Japanese-style employment practices.' These practices consist of long-term employment (or 'lifetime' employment), a seniority-based wage system, promotions in internal labor markets, intra-firm labor unions, and long-run on-the-job training (OJT). Intra-firm labor markets were formed with equal opportunity given to all newly-recruited workers, with a slow promotion process (in selecting winners), and with active 'visible' competition among the participants. This kept young workers motivated.

Reflecting these employment practices, labor adjustments were performed mainly through lengthening/shortening working hours, wage adjustments, and intra-firm job transfer, rather than through layoffs. This prevented the rate of unemployment from rising even during recessions. Labor unions were organized as intra-firm organizations. The union membership was usually extended to both white- and blue-collar workers.

(Development of These Practices)
Before WWII, Japan's labor market was more like that written in an economics textbook. Although some big businesses had introduced long-term employment practices for their core white-collar workforce, manual workers (blue-collars) were most likely hired in spot markets. In 1937, in order to secure labor-employer cooperation in serving the nation, intra-firm unions encompassing both white-collar and manual workers were organized. These practices survived throughout the post-war development period as they had systemic advantages, such as a high level of worker morale, cooperative behavior among workers, firms' positive attitudes toward long-term human resource investment and OJT, and employees' positive attitudes toward technological innovation.

Advantages From microeconomic viewpoints, these practices were effective means to (1) overcome difficulties associated with asymmetry of information regarding employees' abilities and work ethics, (2) promote workers' faith toward their companies through 'reputation' and 'hostage' mechanisms, (3) settle conflicts of interest in intra-firm negotiations, and (4) facilitate transfer of skills among workers.

3) Adjustments in the 'Japanese-Style Market System'

(End of 'Catch-Up' Process)
The catch-up process seemed to have reached its successful conclusion by the end of the 1960s, at least as indicated by the level of per capita GDP (PPP). However, the economic system that brought about the successful 'catching-up' did not itself evolve, or adjust to the new needs in the post catch-up era. The traditional process of consensus formation played a significant role again at the time when Japan faced the first oil crisis of 1973-74. In order to cope with the quadruple price increase of imported oil and the resultant stagflation, economic agents implicitly agreed, as directed by the government, to accept tough industrial and employment adjustments and not to rely on accommodative macroeconomic policies for recovery. Eventually, the Japanese economy overcame high energy prices by energy-efficient manufacturing processes and products, and this, in turn, strengthened the international competitiveness of Japanese products. The Japanese economy weathered the second oil crisis of 1979, again without significant inflation or commodity shortages. In retrospect, however, this resulted in a survival of the modality of consensus formation, collective actions, and government leadership that was no longer suitable in the post catch-up era.

After the catch-up process was over, exogenously given goals for business and technology development no longer existed. Companies had to create their own goals and management strategies suited for their new targets. The elaboration of explicit goals and strategies by top management had become indispensable.

(Into the 'Bubble' Economy)
In the second half of the 1980s, Japan developed a 'bubble' economy. Major factors that drove the Japanese into the speculative boom were competition among firms seeking an expansion of their company size, competition in the banking sector to expand the loan

supply and other investments without due consideration of credit risks, and economic stimulus measures taken by the Bank of Japan and the government in the face of the Yen's rapid appreciation after the Plaza Accord. Many factors were attributable to the Japanese-style market system. The lack of sound corporate governance both in non-financial and financial entities, and the social consensus demanding job security as a result of the ingrained long-term employment practices can also both be blamed.

<u>A lack of 'real' investment opportunities and the non-emergence of potential key industries are main contributors to the dangerous creation of a financial bubble.</u>

(Low rate of economic growth persisted after the bubble burst)
After the collapse of the 'bubble' economy in early 1991, the Japanese economy rapidly fell into recession. It technically bottomed out in late 1993, but the recovery process was slow and fragile, with an average annual growth rate of only one percent plus throughout the 1990s and the early part of the 2000s.

(Changes in employment practices)
During this post-bubble period, the Japanese economy experienced negative growth in real terms in two different years. The unemployment rate that used to be only one to two percent until the early 1980s steadily rose to 5% in 2000. The share of 'non-regular' employees, such as part-time workers, fixed-term workers, and temp workers sent out by 'temp agencies,' had drastically increased, signifying a departure from the long-term employment practice. (By 2008, a full one-third of the labor force is in this non-regular format.)

(End of the 'convoy system')
Corporate profits stagnated. As a result of the accumulation of non-performing loans and the plunge in the market values of equities, some major financial institutions (e.g. Hokkaido Takushoku Bank, Yamaichi Securities, both in 1997) went bankrupt for the first time in the history of post WWII development of the Japanese economy. This signified the end of the 'convoy system.'

(Persistent deflation)
The Japanese economy experienced persistent deflation starting in the middle of the 1990s (which has in fact just recently ended). This, too, was a phenomenon never before experienced in the post-war development of Japan.

('Lost Decade')
Thus, the Japanese economy suffered significant stagnation, and the decade after the bursting of the bubble is now called the 'lost decade' in post-war Japanese development history. It was only after 2002 that the economy entered a steady, albeit weak, recovery phase.

(Japanese budget balance in comparison to the other industrial economies)
In the 1990s, most industrialized economies consolidated their budgets, and some even attained budget surplus. Japan, on the contrary, experienced a sharp deterioration of the budget balance, from a surplus in 1990, to a massive deficit of more than 7% of GDP by

the turn of the century. As the social security account has maintained a surplus of about 2% of GDP during this period, the central and local governments have been in fact running a deficit worth about 9% of GDP.

Budget deficit has been largely financed by issuance of government bonds and by other kinds of borrowings. As a result, the outstanding government debt has reached 160% of GDP. Japan is now the country with the world's largest government debt.

Structural Reforms in the Japanese Development Model

(Rationale of the system)

The Japanese-style market system consisted of (i) an employment system utilizing long-term employment, seniority-based wage structure, on-the-job training and intra-firm labor unions, (ii) a main-bank system, (iii) corporate management by managers promoted from employees, (iv) corporate groups united by cross share-holding, (v) a long-standing trade relationship between parts suppliers and assembly producers or between manufacturers and distributors, the so-called *keiretsu*, and (vi) long-term relationships between the government and business sectors through industrial policy and public regulations.

It was believed that the aforementioned deep, longstanding relationships would mitigate the problem of asymmetric information, such as agency problems between employers and employees, and between bankers and borrowers. It also brought about a long-term perspective in corporate management and facilitated long-term strategic investment. However, in the post catch-up era, this same system appears to have helped bring about problems such as the *bubble* economy of the late 1980s and the persistent low growth throughout the 1990s and beyond, even to present day.

(Changing environment and challenges to the system)

The major challenges to the Japanese-style market system are: (i) changes in the industrial structure and business environment, brought about by an advancement of information and telecommunication technology, which calls for more flexible and timely management and transactions; (ii) the ongoing process of globalization and mega-competition; (iii) the aging of the population and workforce; and (iv) changes in people's values. These evolving factors have undermined the effectiveness of the traditional system, and call for a systemic change for further economic development.

(Structural reforms and a system evolving for the future)

Japan's ongoing structural reform combines a transformation of the economy into a more market-oriented system with less government interventions/guidance, while still utilizing the advantages of the traditional Japanese system. Key words for this reform have been 'marketization', 'choice', 'competition', 'diversity,' and 'own risk.' There is still great potential for taking further advantage of information sharing. The government, redefined from its earlier role, needs to create institutions to coordinate with this evolving system and ensure it fully integrates into this new paradigm. In reality, the pace of change differs and there is not a complete and total break with the past. Various systems, some of which are more market-oriented and others which rely more on institutional trade relations, will continue to co-exist with dynamic competition among them.

(Building Institutions of Coordination:
From Interventionist Government to Coordinator Government)
The necessity for basic structural reform, or marketization, extends to a wide range of the Japanese economy. Three sectors of the economy have their own reform agenda: i) business and financial sectors must reform themselves to enhance business and investment opportunity; ii) individuals or the household sector must accept the discipline of self-reliance; and iii) the government sector must transform itself into a compact and efficient government respecting/utilizing market forces and utilizing decentralization in a strategic manner.

Changes in business and the government sectors must be compatible with (and accompanied by) those in the household sector. Self-reliance of individuals involves shifts in lifestyle, from the traditional reliance on the business community to self-decision-making and risk-taking in choosing jobs and careers that require investments in the individual, by the individual. Self-responsibility should be nurtured in the business sector, as opposed to relying on protection through regulation. The banking sector should stand on its own without the MOF-led 'convoy' system'.

Generally speaking, in the business sector, various reforms have already been started to get out of the long stagnation of the 1990s. As for the government sector, some reform initiatives have started in the areas connected to business, such as regulatory reforms and partial tax reforms. However, for public sector-specific reform areas such as administrative reform and government decentralization, the process has been much delayed. Budgetary reform had just begun under the Koizumi administration. As for the household sector, it will take a long time for the majority of people to change their lifestyle and way of thinking.

As the majority of the reform efforts and new initiatives should be happening in the cross-sections of the three sectors, the building of <u>'institutions of coordination'</u> or, in other words, nurturing the <u>'social capital of intra- and inter-sector networks'</u> is imperative. The role of the government should be redefined in precisely this context. That is, a change from 'interventionist government' to 'coordinator government' is now most urgently called for.

5. <u>Global Changes/Imbalances and the Path and the Roles of China</u>

(No script is provided in this section.)
(Free discussion with PowerPoint slides.)

And with that, I have reached the conclusion of my presentation. I'd like to open the floor to any questions or comments you have, keeping in mind that this is an opportunity for me to learn from your insight and experience, as well.

The fundamental question we all have to answer is whether we have the determination and the commitment to partner in development and move this dialogue forward.

Thank you!