

**"JAPAN'S ECONOMIC CRISIS"**

**BY**

**NOURIEL ROUBINI**  
**Stern School of Business**  
**New York University**

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## Introduction

Only a few years ago Japan was viewed as an exemplary economic success story and a model of successful economic long-run growth. People talked of “Japan Inc.” and the Japanese growth model was being suggested as a case study to be followed by other developing and developed countries. Conversely, the US economy at the end of the 1980s seemed affected by a serious malaise: low growth, a sharp recession in 1990-91, large trade imbalances, a weak dollar, a hollowing out of the manufacturing sector and persistent talk of a structural decline of US power. The book by Yale historian Paul Kennedy “The Rise and Fall of the Great Powers” touched a raw nerve in the US by suggesting that political and strategic decline are historically caused by economic mismanagement and poor economic performance.

Today, the situation appears almost exactly reversed after four year of serious economic recession and turmoil in Japan and four years of dynamic economic performance and competitive resurgence in the US. Because of a dramatic restructuring process over the last decade the US economy is now “lean and mean”, highly productive, with low labor costs, highly innovative and very competitive in world markets. The US is ranked #4 in competitiveness according to the recent “World Competitiveness Report” and Japan only #13.

We must admit that if a few years ago the success of the Japan model was being hyped up too much and the malaise of the US economy exaggerated, it is likely that now the weaknesses of Japan might be exaggerated as well. However, I will argue that the Japanese economy suffers of severe problems that are not only cyclical but more structural in nature. Such structural problems are the most serious impediments to entrepreneurship, economic dynamism, innovation and the future long-run economic success of Japan.

## Current Macroeconomic Problems of Japan

I will first start with an overview of the current Japanese macroeconomic problems before moving to the more structural issues. In summary, in the last four years we have observed in Japan:

### 1. Poor growth performance:

- a. GDP growth was close to zero on average in the 1992-1995 period
- b. Only modest recovery in 1996
- c. Fall in GDP in 2nd and maybe 3rd quarter of 1996
- d. Slow growth (or recession) expected in 1997 (2.7% IMF estimate).

### 2. Serious fiscal problems:

- a. Large and growing budget deficits (as a % of GDP). 1990: 0.7%; 1996: 4.2%; 1997: 3.2% (estimate)
- b. High and growing public debt to GDP ratio. 1992: 63%; 1996: 89%; 1997: 95% (estimate)
- c. In the long run the fiscal problem is even worse because of demographic trends (aging of the population). There are serious implications for the solvency of social security system that may be bankrupt in a few decades. In this there are similarities with the US situation.

### 3. Weak labor market conditions:

- a. Stagnating employment growth and serious employment uncertainty
- b. High unemployment rate (3.3%) by Japanese standards
- c. Loss of jobs due in part to a process of deindustrialization as large scale Foreign Direct Investment (FDI) exported Japanese jobs to Asia and US
- d. Trend towards “hollowing out” of the Japanese manufacturing sector.

### 4. Weakening of the trade and external accounts of the country:

- a. Lowering of the trade and current account surplus. CA/GDP: 1994: 2.8%; 1996: 1.2%
- b. Strong depreciation of the Yen relative to 1995 high levels (by 40% with respect to US \$)

c. Structural long-term reduction of the trade surplus because of falling private and public savings rates. Private savings will fall because of demographic trends. Public savings fall also in the long-run because of the problems of the social security system

d. A guess: the reduced current account deficit will significantly reduce trade tensions between the US and Japan in the short and medium run.

#### **5. Excessively loose stance of macroeconomic policies:**

a. Very loose monetary policy to stimulate recovery and save the collapsing banking system.

Nominal short term interest rates are close to zero

b. Very loose fiscal policy to stimulate growth (a boom in “public spending and investment”)

c. A policy of weakening of the Yen to stimulate growth. The monetary and fiscal policy stance and the structural problems explain the Yen weakness. In this regard see the recent view by Fred Bergsten (*The Economist* November 2, 1996) on the active attempt of the Japanese to push down the values of the Yen and the alternative view expressed by Mr. Yen (Mr. Sakakibara) last Thursday.

I will argue that in Japan there is a need for structural reform rather than better short-term management of macroeconomic policies in order to address the structural problems of the economy. Further fine-tuning of macro policies will not work:

a. in the short run since both monetary and fiscal policy are as loose as they can be

b. in the long run since the Japanese problems are not cyclical but structural.

**My main argument: the traditional Japanese Growth Model does not work any more in the new international economy; Japan needs structural reforms.**

## **Features of the Traditional Japanese Growth Model**

What were the features of the old economic growth model and of the Japanese social and institutional system as compared to the US ?

To the risk of simplifying things, I would argue that Japan had:

1. An economic and social system valuing social cohesion and collective goals over individualistic pursuit of personal welfare; pursuing consensus over conflict; emphasizing cooperation versus aggressive competition; valuing conservative risk aversion versus aggressive risk-taking.

The recent book by Fukuyama “Trust” argues in favor of such Japanese values by stressing the role of “trust” and “social capital” in economic development .

2. An economic system based on limited market competition and oligopolistic market structures as opposed to free market competition

3. Strong amount of regulation and government intervention in most markets as opposed to aggressive deregulation

4. A relatively protectionist trade regime, emphasizing exports over imports and restricted policies towards inward FDI policies

5. A system of life-time job security versus high job mobility and insecurity

6. Implicit and explicit systems of social insurance for firms and households to address the overall risk-aversion behavior of agents in the economy. Contrast this with the strong American risk-taking attitudes

7. A corporate organization system based on Keiretsu instead of “holding companies” and unrestricted Mergers and Acquisitions

8. A R&D model based on “process innovation” rather than “product innovation”, i.e. based on the quality improvement of already existing goods rather than the creation of new goods

9. An educational system emphasizing traditional values over innovation and individual creativity.

This economic and social model worked in an excellent way from 1960 until 1990. The old model worked so well for Japan that it became the “Growth Model” followed by several East Asian countries. But this growth model does not seem to work in the 1990s.

The crucial question is: is the experience of the 1990s just a temporary and cyclical blip that does not put in question the old growth model or is the traditional economic regime now partially flawed and in need of structural change and reform ?

I will argue that the latter is the case. What has changed in the last decade to make obsolete the old growth model ?

## **Why is the Traditional Growth Model Not Working Any More ?**

Many authors have advanced the hypothesis that higher growth in the new global economy is associated with greater risk-taking, dynamic entrepreneurship and more aggressive competition rather than the low risk model of the last few decades. Michael Mandel (the Economics editor of Business Week) calls this the emergence “The High Risk Society” in his recent book. The old growth model does not work anymore because of four fundamental new trends in the world economy:

- 1. Structural change in the nature of technological innovation.**
- 2. Greater global trade competition**
- 3. Deregulation that is fostering competition**
- 4. Corporate restructuring.**

Lets consider these trends in more detail.

### **1. Structural change in the nature of technological innovation.**

First of all, it has been argued that the nature of technological innovation has changed. From the 1950s until the early 1980s, innovation took the forms of already existing technologies and goods that had to be improved in quality (examples are: cars, stereo systems, photographic equipment, other consumer electronics goods). The Japanese were best at doing this as being the best in “process innovation”, “quality improvement” and “product imitation”.

Today, technological innovation is very different because of qualitative changes in technologies and the rapid appearance of new and very different products (computers, software, Internet and information technologies, advanced chip technologies, telecommunication goods and services, new financial instruments and services). These products are appearing and changing at such a dizzying pace that an imitator cannot catch up with the product and technological leaders. The product cycle of innovation has become drastically shorter. Extreme example: the Internet Browsers and the war between Microsoft and Netscape. So, today you either innovate and remain on the cutting edge of the technological wave or you will remain forever behind.

To put it bluntly, a mainstream view in the United States right now is that in all these new technologies and products Japan is completely behind the US and will be unable to catch up. A recent Wall Street Journal editorial piece right after the Japanese elections (October 22) offered a very harsh expression of the current typical US views of Japan: “After having spanned a cottage industry of books on how Japan would “take over the world”, Japan now leads in few of the important industries of the late 20th century”. While such a view might be particularly harsh and incorrect in several respects, it conveys the perceived American reversal of fortunes in the contest about the right model of economic growth.

### **2. Greater global trade competition**

Increased global trade has led to global competition and the need for industrial restructuring. The US suffered in the 1980s from freer trade, trade competition and the strong dollar value but this major economic shock led to a dramatic process of corporate restructuring.

Japan until recently did not liberalized trade as much and delayed this structural adjustment. The strong Yen trend until 1994 led to significant import penetration, loss of manufacturing jobs and the export of jobs to other East Asian countries through a major process of outward FDI. However, domestic corporate restructuring has been very slow.

In this regard, the significant fall of the Yen since 1995 is a bad omen for Japan because, while giving short-run breathing room to the battered industrial sector, it dilutes the incentives for structural restructuring and slows significantly the drive to change. Also, the regulated and non-competitive non-traded sector of services has not been affected by the external trade liberalization pressures as much as the traded manufacturing sector. So the global trade pressure to reform has not hit the service sector.

### **3. Deregulation policies fostering competition**

Since the early 1980s the US experienced a major process of economic “deregulation” in all sort of sectors of the economy including manufacturing goods, services, traded and non-traded goods. Such policy of deregulation led to competition, pursuit of efficiency and major economic restructuring. While there is a lot of talk and policy proposals for major deregulation of the economy in Japan, this has not occurred yet in any significant scale.

### **4. Corporate restructuring**

The combined forces of technological change, trade competition, deregulation of the economy led to major corporate restructuring in the US that took the forms of

- a. Re-engineering
- b. Out-Sourcing
- c. Large scale Downsizing of firms
- d. Massive corporate control restructuring through Mergers and Acquisitions

Because of this dramatic restructuring over the last decade the US economy is now highly productive, with low labor costs, highly innovative and very competitive in world markets.

Of course, there were very high social costs of this restructuring process first for blue-collars and now for white collars and managers:

- a. Major job turnover
- b. Great job insecurity
- c. Need for disrupting occupational and regional mobility
- d. Depressed real wages for average workers
- e. Significant increase in income and wealth inequality

However, such corporate restructuring has led to higher productivity growth, a resurgence of manufacturing, high employment growth and low structural unemployment rates.

In Japan instead the strong Yen of the early 1990 led to outward FDI, the hollowing out of the manufacturing sector, significant jobs losses but no major structural reform of the economy. Reform has been very slow because of the following factors:

- a. The lack of major economic deregulation
- b. The persistency of oligopolistic structures and lack of market competition
- c. The still relatively protective trade policies and inward FDI policies
- d. The recent weakness of the Yen

While these factors have sheltered Japan in the short-run from the brutal logic of the new world economy, they have also significantly slowed down the pressures for reform. So in the long-run, Japan might be much worse off for delaying the needed structural reforms of the economy. Therefore deindustrialization in Japan may become more permanent than transitory

In US less welfare and labor mobility means more uncertainty, more income/wealth inequality, lower real wages but it also means employment for everyone. In Europe, there is a welfare system where the “insiders” are guaranteed jobs and high real wages but they have to pay high taxes to support the “outsiders” (i.e. unemployed). While differing from Europe in many respects, Japan has a number of similar structural rigidities in labor markets.

In the view of an Stephen Roach, an influential Wall Street analyst who has studied the US restructuring for over a decade: “The road to European and Japanese competitive revival is going to be a

lot longer and more arduous than which the US has traveled since the early 1980s” (Financial Times, October 22, 1996).

Probably, the different social culture and history of Japan suggests that Japan will not and should not follow the brutal “Wild-West” American model of restructuring and reform. However, there is need in Japan for major structural reforms and economic deregulation in order to foster entrepreneurship, risk taking, innovation and long-run growth. Japan will have to find its own national path to reform and change but the process is going to be painful. Also, delaying these reforms will not help because short-run reduction of the pain might lead to more serious problems in the long-run as the persistence of the recession for over four years now suggest.

## **Required Policies for Structural Reform**

The policy changes needed to deregulate the economy and foster competition and entrepreneurship are now quite well know and object of serious policy debate in Japan. We ca summarize them as:

### **1. Financial markets liberalization (important role of financial markets for growth):**

- Financial restructuring of the banks and reform of banks’ supervision activities
- Liberalization of derivatives markets
- Liberalization of insurance markets and services
- Expansion of shareholder rights
- Improvement of disclosure procedures
- Creation of an independent institution similar to the US Securities and Exchange Commission
- Develop venture capital institutions
- Allow the formation of holding companies.

### **2. Deregulation and fostering of competition in domestic markets:**

- Improve services productivity through deregulation and competition. Right now the low productivity service sector is a main drag on the economy and negatively affects the competitiveness of the export sector as well. Sectors requiring deregulation include retail, transportation, telecommunications, telephone service. Example: you can’t really tap into the Internet with an archaic phone network
- Foster competition through further trade liberalization and avoid further Yen depreciation
- Reduce oligopolies with aggressive competition policies.

### **Administrative and political reform:**

- Reduce the powers of the bureaucracy
- Reduce the power of the Ministry of Finance and dismantle it into several smaller agencies
- Regional decentralization to reduce central power
- Change the voting system towards a pure majoritarian system that will in the long-run lead to a two-party system. Evidence on the benefits of a two-party system over coalition governments.
- Reduce the number of government ministries

### **Educational reform:**

- Foster basic research rather than applied research in the universities and academic research institutions
- Stimulate other forms of basic research (via government funded research)
- Develop a system of merit-based rather than seniority-based promotion in research and academic institutions
- Foster individual innovation and creativity in the educational system.

## Concluding Remarks

Will Japan be successful in facing these challenges? There are reasons for both optimism and pessimism.

On the negative side:

1. Historically Japan reformed only after major crisis that broke the deadlock in society in favor of drastic reform. Today instead there is stagnation but not crisis.
2. The election results appear to support the status quo rather than reform. Also there is going to be continued political instability and government weakness that usually leads to inertia rather than major policy changes.
3. The Yen is now weak and this delays the incentive to reform.
4. The big corporations (Sony, Honda, etc.) are very international and their fortunes depend less on the success of the Japanese economy; they have now less at stake if reform does not occur.

On the other side, there is reason for optimism:

1. History shows Japan's ability to reform and adapt fast in periods of crisis (examples are the Meiji Restoration and the Post-War World II development).
2. There is significant pressure (in the business sector and urban classes) for economic reform, deregulation and more competition.
3. The official policy program of the current government recognizes the need for urgent administrative and economic reforms.
4. The Japanese have repeatedly shown to be hard working, creative, willing to sacrifice personal interest for the collective goods, and willing to respond to challenges.