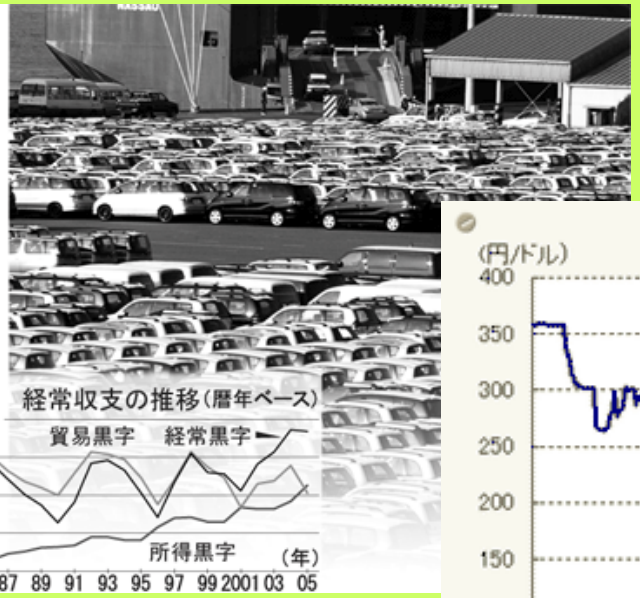
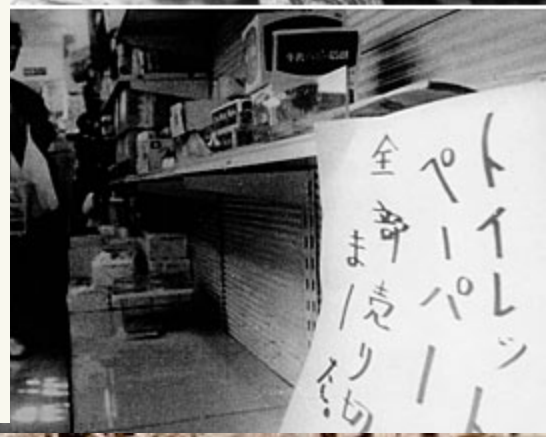
Economic Development of Japan

TRADE



YEN



OIL

No.13 Economic Maturity & Slowdown

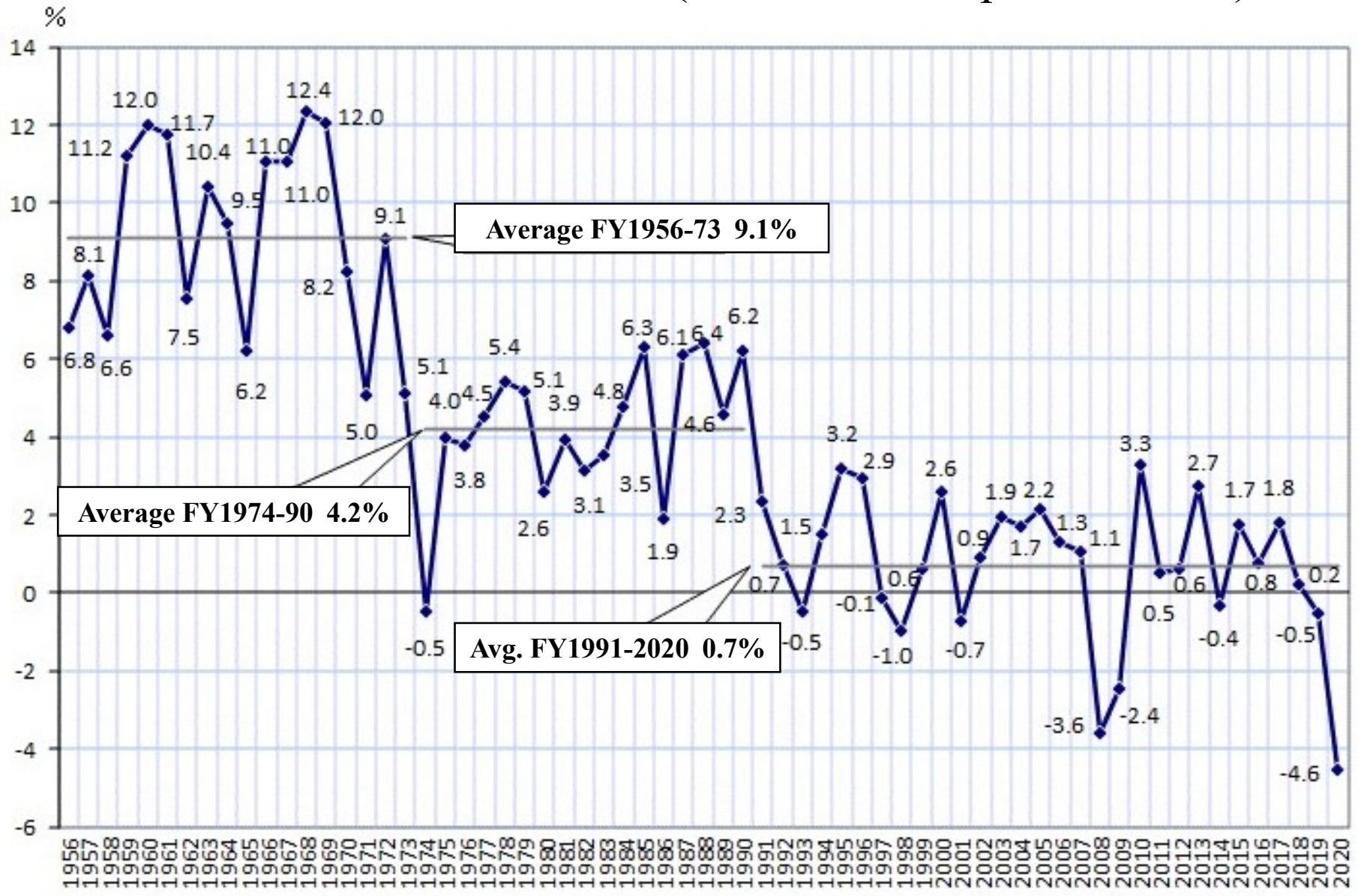
Topics for Discussion

- What were the internal and external causes of slowdown of Japanese economic growth in the 1970s?
- Explain the pattern of bilateral trade disputes with the US and Europe. How did they affect Japan's macroeconomy and structural reforms?
- Evaluate the speed of Japanese economic reform toward freer and more open economy after high income was achieved around 1970.
- Did Japanese society experience rising income gaps during and after the accent to high growth? Why or why not?

Slowdown Begins in the 1970s

- After growing nearly 10 percent per annum from the late 1950s to early 70s, the Japanese economy grew about 4 percent per annum from the mid 70s to 80s. Growth further slowed down to almost zero in the 1990s and beyond.
- The domestic reason for slowdown was economic maturity. By around 1970, Japan roughly caught up with the US and Western Europe in terms of income level and competitiveness. Growth at the top is inevitably slower than growth during the catch-up period.
- The external reason for slowdown was macroeconomic instability: the two oil shocks and resulting global *stagflation*—business recession with high inflation—which affected virtually all nations.
- The Bretton Woods system—the postwar system of the US dollar-centered fixed exchange rates—collapsed in 1971-73, ushering in a period of general floating of major currencies. This added uncertainty to the global economy.
- Economists hotly debated the cause of stagflation in the 1970s. Many blamed aggressive oil price hikes by oil exporting countries (supply-shock view). Others pointed to the inadvertent expansion of global money at the time of the collapse of the Bretton Woods system (global monetarist view).

Real GDP Growth (Fiscal Year – April to March)

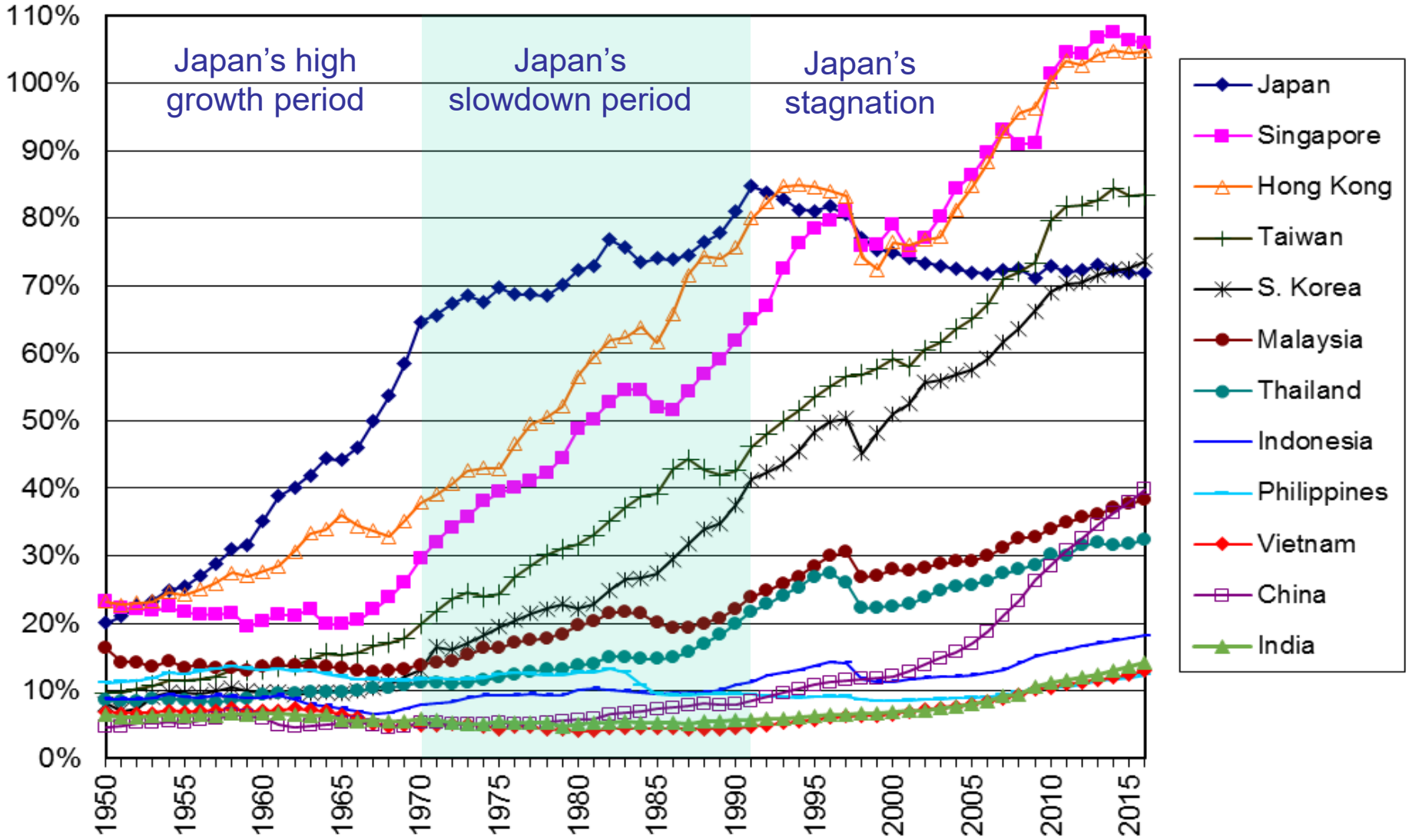


Source: The System of National Accounts website, Cabinet Office.

Catching Up with US Income

Per capita real income relative to US

(Measured by the 1990 international Geary-Khamis dollars)

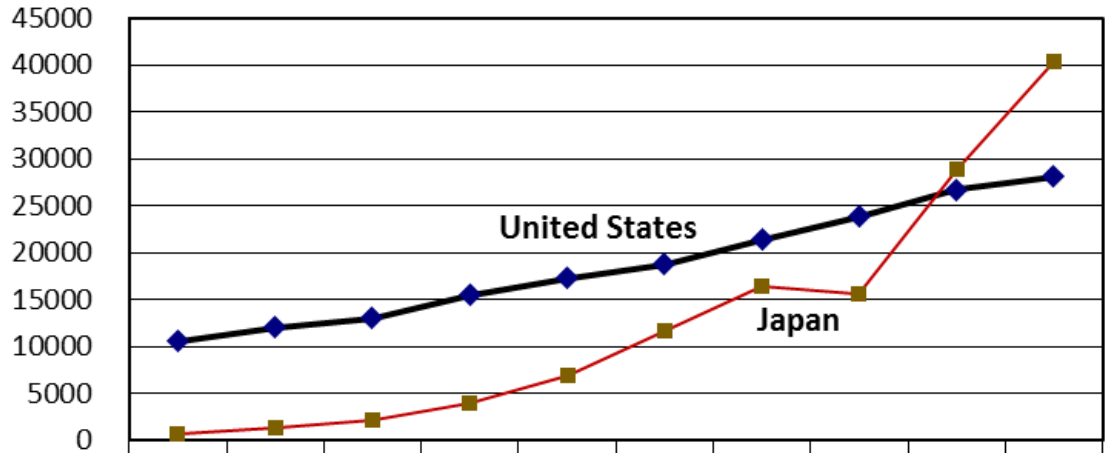


Sources: Angus Maddison, The *World Economy: Historical Statistics*, OECD Development Centre, 2003; the Central Bank of the Republic of China; and IMF, *World Economic Outlook Database* (for updating).

Japan Rejoins the High Income Club

Catching Up with the US in Real Per Capita Income

(1995 dollars, conversion at actual exchange rate)

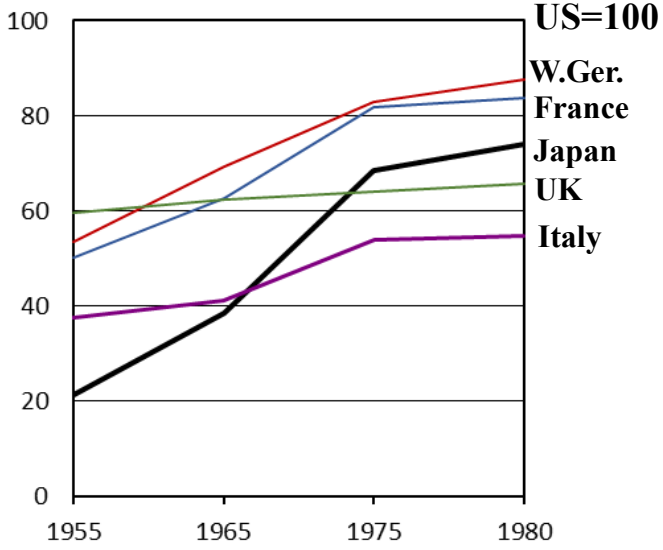


	1950	1955	1960	1965	1970	1975	1980	1985	1990	1994
US	10582	12060	13046	15454	17310	18754	21392	23858	26744	28157
Japan	776	1336	2127	3984	6962	11676	16486	15658	28912	40421

Note: Japanese income was temporarily higher than US income in the last two observations mainly due to the excessively high yen. It subsequently fell below the US level.

Per Capita Income

(US income = 100)



Thanks to high growth, Japan caught up with most Western nations. By the mid 1970s, Japanese income per head was higher than that of the UK or Italy. Toyota Corolla became available after working for a few months instead of nearly a year.

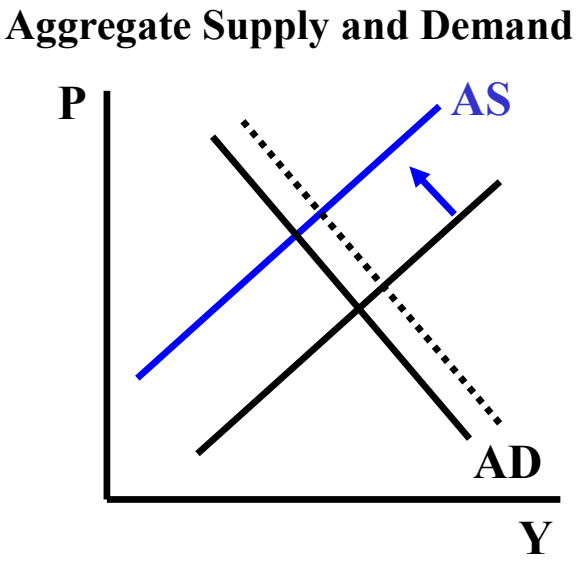
Affordability of Toyota Corolla (basic model)

Year	Model/make	Price	Average monthly wage	Number of wage-months
1966	Standard	¥432,000	¥40,510	10.7
1968	SL	¥557,000	¥52,699	10.6
1970	Standard 2-door	¥438,500	¥71,447	6.1
1974	Standard 2-door	¥581,000	¥146,464	4.0
1979	Standard 2-door	¥718,000	¥227,753	3.2
1983	DX 4-door	¥863,000	¥279,106	3.1
1987	Custom DX 4-door	¥883,000	¥313,170	2.8
1991	DX 4-door	¥898,000	¥368,012	2.4

Cause of Stagflation in the 1970s

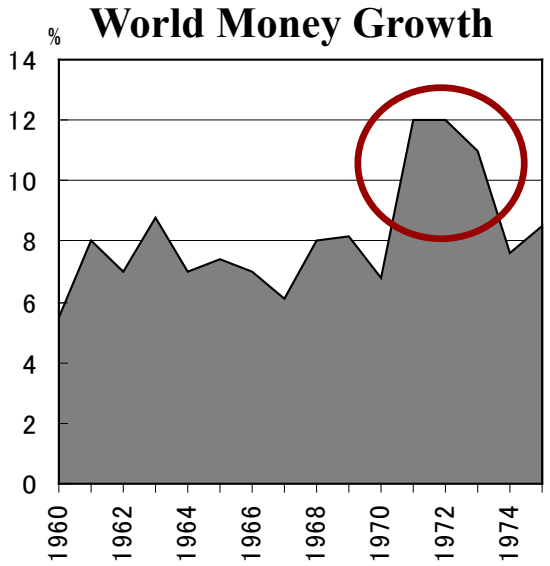
Supply shock view

- Oil price increases with political motivation by the Organization of the Petroleum Exporting Countries (OPEC) were the main cause (blue line). Aggressive wage hikes, especially in Europe, also contributed.
- In reaction, most governments turned to monetary and fiscal expansion to minimize employment and output loss at the cost of a bit higher inflation (dotted line).



Global monetarist view

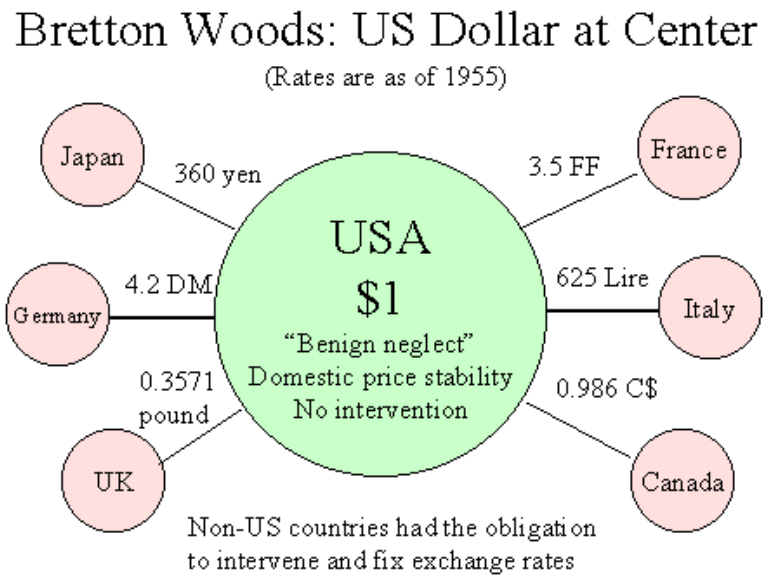
- As the US lost monetary discipline (see next), fixed exchange rates collapsed and USD fell in 1971-73.
- European and Japanese central banks expanded money to counter appreciation of their currencies, creating global liquidity glut in the early 1970s.
- The first oil shock of 1973-74 was the result, not the cause, of global inflation. OPEC's action would not have succeeded without global money expansion.

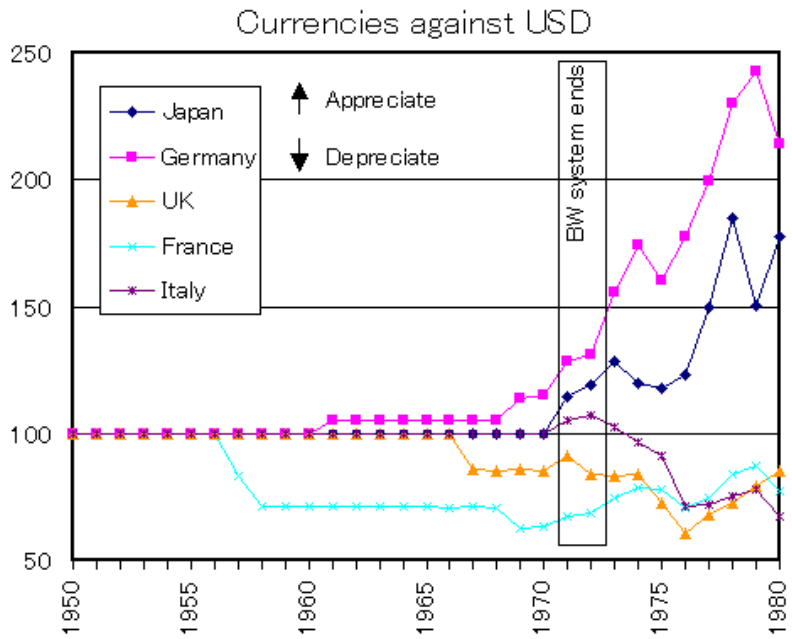


Source: McKinnon (1979), p.264

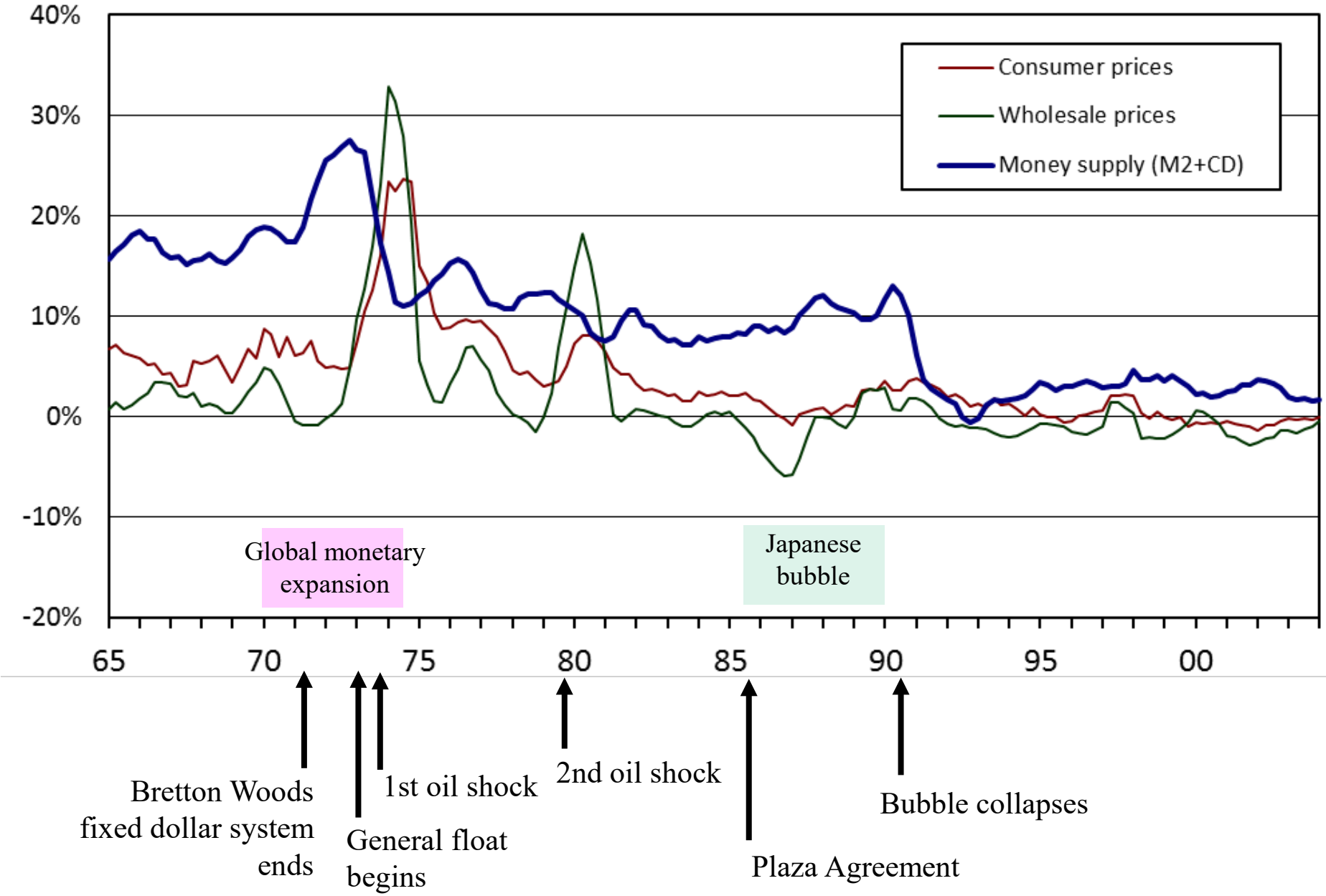
Post WW2 Bretton Woods Dollar Standard

- The US was the center country providing price stability to the world. It was obliged to mind domestic economic stability only ("benign neglect") while all other countries fixed "parities" (exchange rates) against USD. Occasional adjustments were allowed. Gold guaranteed the value of USD which guaranteed the values of other currencies.
- **1950s-early 60s**: American prices were stable; the Bretton Woods system achieved global high growth and price stability.
- **Mid 1960s-early 70s**: the US began to inflate (the war in Vietnam, social welfare and the space race with USSR), and USD came under downward pressure.
- The gold-USD link was broken (1968); The USD-other currencies link was terminated (1971-73: Nixon Shock). Major currencies started to float.





Japan: Money Growth and Inflation (12-month change)



Bilateral Trade Friction

- The US was (is) the largest economy in the world with significant "dissaving" (investment is greater than saving; spending is greater than income). Because of this, the US must inevitably run a trade deficit (import more than export).
- The US routinely blames a nation which provides needed savings to the US by generating a large trade surplus (a large trade deficit for the US). From the macroeconomic viewpoint, this is natural lending and borrowing in a world where countries have different spending patterns. If the US desires to reduce its trade deficit, it must cut spending or boost production, or both.
- However, many American economists and Washington lobbyists pressure their government to narrow bilateral trade gaps by forcing "corrections" on partner countries. It usually demands appreciating the currency and ending "unfair" trade practices of the surplus country.
- This was tried intermittently but forcefully from the 1960s to the 1990s against Japan. Every time US pressure heated up, the Japanese yen appreciated greatly (1971-73, 1977-78, 1985-87, 1993-95). From the mid 1990s to present, China overtook Japan as the main target of US mercantile diplomacy. But the US trade deficit continues to grow. President Trump applied the same "solution" with more noise.

History of Trade Disputes with US

- The history of Japan's trade friction with the US—and, to a lesser extent, with Western Europe—is long and highly politicized.
- It began in the 1960s when Japan was exporting cheap apparel ("one-dollar blouse") to the US. In response to American complaint, Japan was forced to adopt "voluntary" quotas on textile export.
- From then on, a stream of Japanese products came under attack: steel, TV sets, machine tools, automobiles, video players, semi-conductors, etc.
- From the 1980s, besides pressure to export less, the US began to demand that Japan buy more from America: orange, beef, automobile components, and construction and financial services.
- Moreover, US trade negotiators argued that the Japanese economic system was inefficient and closed, and must be reformed. What started as complaints on individual products ended up in general criticism of the economic system of America's major trading partner.

Mercantilist Pressure on Surplus Countries

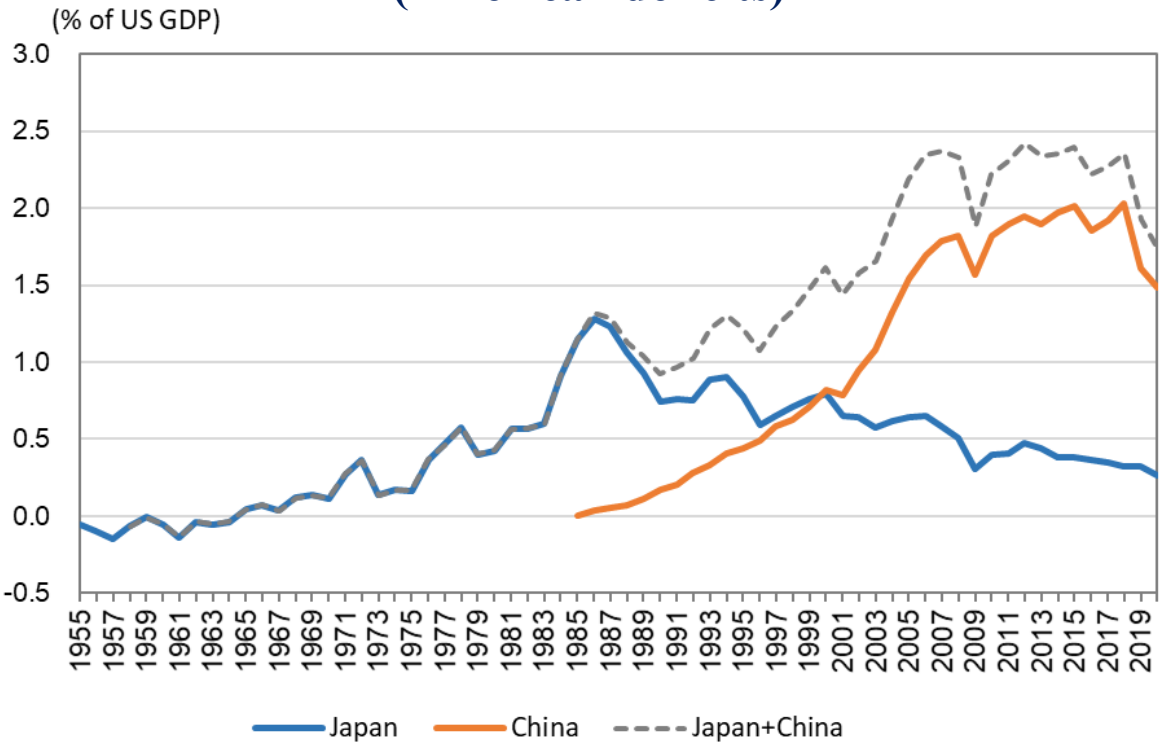
Ronald McKinnon
(1935-2014)

Komiya (1994), McKinnon-Ohno (1997), McKinnon (2005)

When a country emerges as a new industrial power, it is often criticized for unfair trade practice and an undervalued currency. Trade and exchange rate pressures mount. But the trade gap cannot be eliminated by trade liberalization or currency appreciation.

As long as the US continues to outspend its income, some country or countries must supply additional saving to the US. When Japan stopped doing this, China took over the role.

Japan-US & China-US Trade Balance
(American deficits)

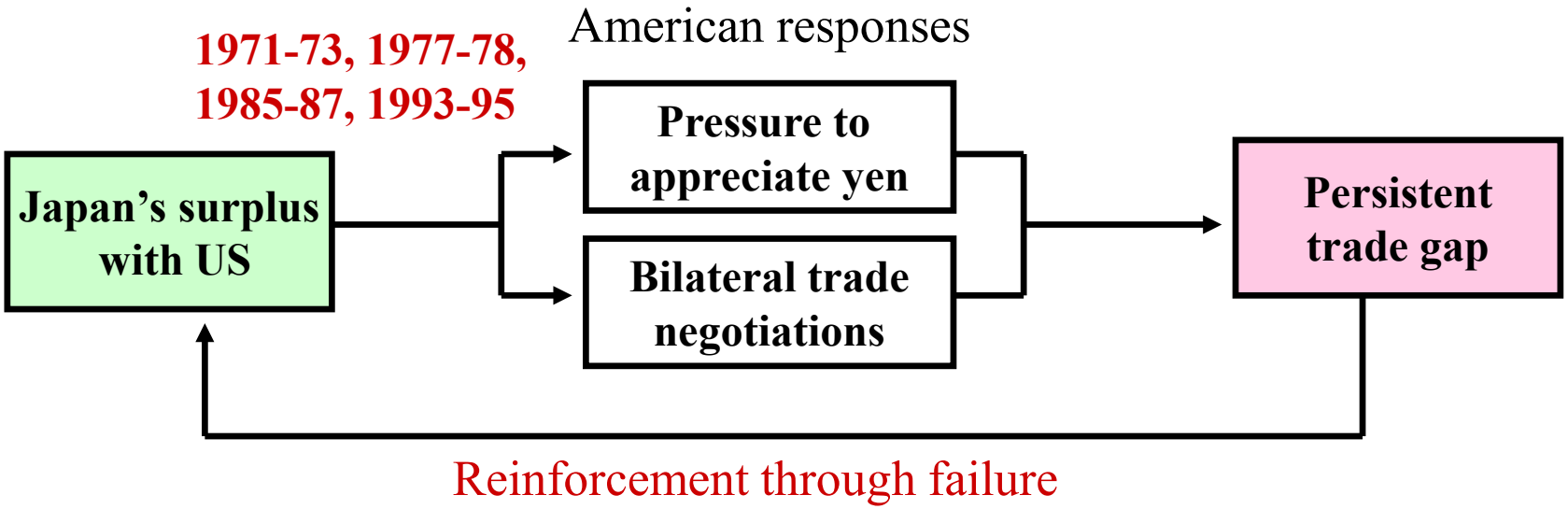


Sources: US Bureau of Economic Analysis, National Economic Accounts, and US Census Bureau, US International Trade Data.

Our unconventional view (syndrome of the ever-higher yen)

- Thanks to wrong economics and Washington lobbyists, the yen-dollar rate was manipulated for mercantile purposes.
- But yen appreciation could not reduce Japan's surplus and US deficit, because it was structural (US savings < US investment). The real solution was increasing US savings.

  Current account = income and spending gap in the US
- Intermittent yen appreciation only destabilized the Japanese economy through recession, deflation and depressed interest rates.



Macroeconomic Identity

(Optional)

- Macroeconomics gives the following national income identity

  $$Y = C + I + G + (X - M)$$

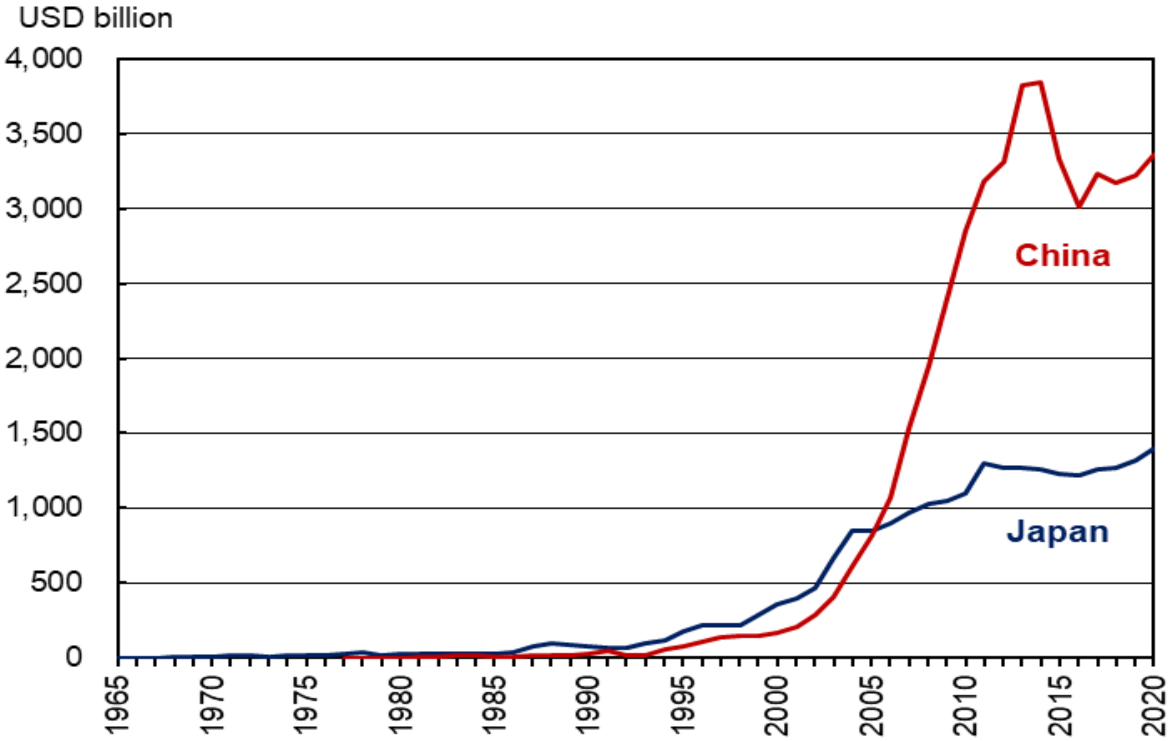
  where Y (GDP or national income), C (consumption), I (investment), G (government spending), X (export) and M (import). Also define A (absorption, or domestic spending) = C + I + G.
- From this, we have X – M = Y – A. In words, a nation's trade balance is identical with its income less domestic spending.
  (Note: precisely speaking, X – M is the *current account* which includes trade balance plus service and remittance transactions. For Japan, the difference between the two was small.)
- A nation's trade deficit is caused fundamentally by its production and spending patterns. It cannot be changed by forcing other countries' behavior.

Why a Stronger Yen Fails to Reduce Japan's Surplus?

- Yen appreciation pushes up the prices of Japanese goods relative to others, which should diminish competitiveness and trade surplus. But this thinking is incomplete because exchange rate movement affects many other conditions.
- A high yen causes (i) Japanese price deflation (which offsets the expected price effect); (ii) Japanese recession (which reduces Japanese import); and (iii) the Bank of Japan's monetary reaction to counter the recession. The total impact is ambiguous theoretically and empirically.

Foreign Reserves: Japan and China

Sources: the Bank of Japan; and the State Administration of Foreign Exchange (SAFE) of China..



- Japan first and China later ran large trade deficits with the US as well as with the world. As a result, both accumulated huge international reserves. Central banks of such countries often buy up USD to resist currency appreciation.
- Japan has a floating currency and free capital movement while the Chinese Renminbi is highly controlled. China's net foreign assets are kept mostly at the central bank (PBC) while Japan's are held both officially and privately.
- Holding excessive international reserves runs the risk of exchange loss as well as the risk of excess liquidity and asset bubbles. Japan stopped accumulating international reserves in 2011 and China in 2014.

Ryutaro Komiya

Economics of Trade Surplus & Deficit (1994)

He also criticized MITI (lecture 12) and BOJ at the time of BW System collapse

"…Japan's huge current account surplus and America's huge deficit—or Japan's trade surplus with the US—have been a cause of economic *friction* between the two countries. Against this trade surplus of Japan, the US has aggressively demanded that we reduce the surplus and open up the Japanese market.

To me, first of all, these demands for reducing the surplus and opening the markets seem extremely illogical and unreasonable. Japan's response to the US in the so-called Maekawa Report [see below] in 1986 was also highly inappropriate.

Second, from the viewpoint of economics, the debate over bilateral current account imbalance is full of elementary mistakes. Stupidity and nonsense rule over this debate. I believe it is my mission as an economist to correct such mistakes and nonsense.

Third, I consider myself an internationalist and not a nationalist, and I am proud of it. But I cannot endure a situation where Japan is unduly criticized by the international community based on misunderstanding, prejudice and malice. I want to refute such criticisms and correct these misguided ideas." (pp.3-4)

Delayed Structural Reform?

- Some argue that the Japanese economic model of the 1950s and 60s, based on *long-term relations* and *active official intervention*, became obsolete by the time Japan achieved high income. Elements of this model included the main bank system, lifetime employment, seniority wages, cross-stockholding, keiretsu, friendly management-labor relations, administrative guidance, etc.
- According to the proponents, Japan should have shifted decisively toward a more market-based, less officially guided system during the 1970s. But external events such as oil shocks, the floating of major currencies and trade friction with the US and Europe diverted policy attention. As a result, Japan failed to make necessary reforms and remains over-regulated to date.
- However, others argue that full conversion to the free market model is not a solution as we now know that uncontrolled capital markets do great damage. Long-term trust and constructive public-private engagement are great policy assets, and any move toward market should be balanced and selective.
- In the 1980s, Japan liberalized external capital transaction and the domestic financial system. State-owned firms such as railway, telecom and tobacco were privatized. *Daini Rincho* and the Maekawa Report advised further deregulation and administrative reform.

Dai Ni Rincho 第二臨調

(Second Special Administrative Reform Study, 1981-83)

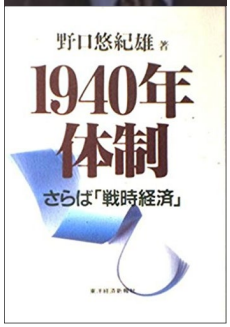
- This was an official advisory body headed by former Keidanren President Doko Toshio, a man of great discipline and austerity.
- The Doko team recommended: (i) fiscal consolidation by cutting bureaucracy and subsidies, not by tax increase; (ii) active international contribution by increasing ODA and military spending; (iii) Japanese-style low-cost welfare society; and (iv) private sector initiatives and privatization of state monopolies.

Maekawa Report

(Economic Structure Adjustment Study, 1986-87)

- This was an unofficial body advising PM Nakasone Yasuhiro. It was headed by former Bank of Japan Governor Maekawa Haruo.
- The Report recommended: (i) avoiding friction with the US by reducing trade surplus [this was criticized by Prof. Komiya]; (ii) domestic demand stimulation; (iii) low interest rate policy [later criticized for causing an asset bubble]; and (iv) implementation of structural adjustment measures such as land deregulation and abolishment of the Large-scale Store Law.

Yukio Noguchi: *The 1940 Regime: Farewell to the War Economy* (1995)



- Noguchi advances the hypothesis that the key components of the Japanese economy today were created during the war years.
- The "1940 Regime" consists of three principles: (i) production-first; (ii) suppression of competition; and (iii) social policies to ameliorate friction. This alien system was implanted for executing a total war and it remained as Japan's systemic core even after the war.
- This regime worked well for post-WW2 economic catch-up, but not for coping with change. Deregulation and consumer-oriented society cannot be realized until this Regime is removed.

Hiroko Ota: *Reform in Reverse* (2010)

- Professor Ota (GRIPS) was the Minister of Economy and Fiscal Policy during 2006-2008 serving PM Abe and PM Fukuda, promoting economic deregulation and fiscal discipline.
- "The Democratic Party government (2009-2012) has reversed the economic reform and reintroduced past policies that do not work any more: fiscal activism and random subsidies leading to fiscal crisis. Economic deregulation slowed down or was reversed."

Yonosuke Hara: *Asia Dynamism: Capitalist Networks and Regional Characteristics of Development* (1996)

- Long-term trust and official support are two ingredients which are critical in any society that wants to move from an early light manufacturing and simple assembly phase to a fuller, more technology-based heavy industrialization.
- The free market of Meiji had to inevitably evolve into a more relational and guided market economy as Japan mastered heavy and mechanical industries in the mid-twentieth century, with or without war.
- All latecomer countries of yesterday and today need such modification to their domestic economic system so development will proceed smoothly and without social crisis.
- Disapproving all relational and state-guided systems as obsolete is too simplistic and without a historical perspective, especially when the world now clearly recognizes the instability and harm that unregulated global markets can bring through asset bubbles, speculative waves, currency attacks and income gaps…

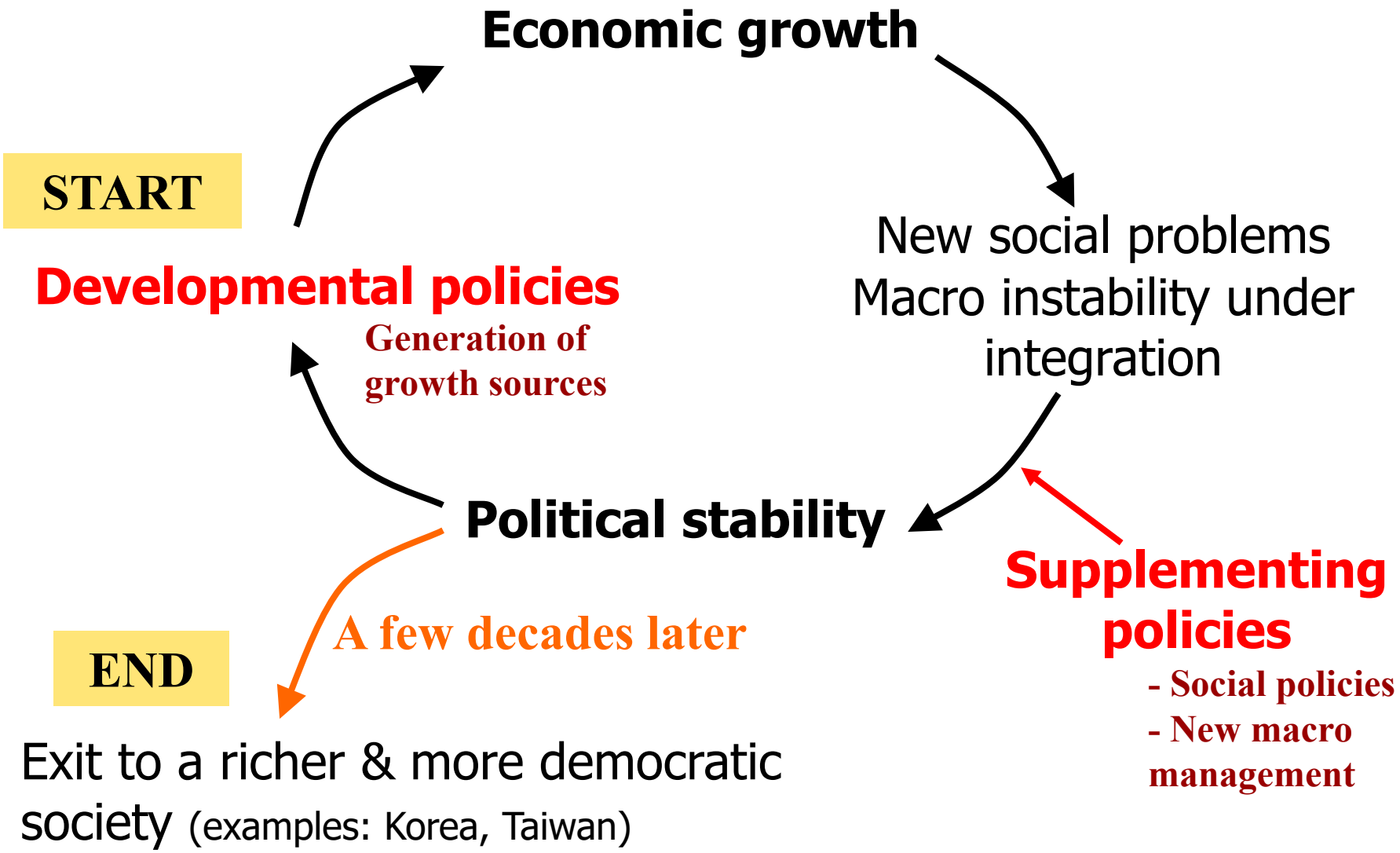
Masahiko Aoki: "The Japanese Firm as a System of Attributes: A Survey and Research Agenda" (1994)

- The Japanese corporate system (J-system) has inter-connected attributes such as Information System (I), Internal Rank Hierarchy (R), Employment Relationship (E), Subcontracting Relationships (S), Main Bank (MB) and Cross-Stockholding (CS), as distinct from the Western corporate system (W-system).
- Superiority of any system depends on market and technology conditions which vary across sectors. Global inter-penetration of firms of different national origins makes things even more complex.
- Ongoing trade disputes raise a fundamental question about systemic evolution. Whether J- and W-system will merge or co-exist, or one will dominate the other, is hard to predict. Westerners should not preach the universal value of free competition, and Japanese should not defend J-system so as to resist reform and opening.
- "It is important for both sides to understand the nature of the two systems more deeply in a comparative perspective." (p.36)

High Growth and Inequality

- There are two types of economic growth in East Asia: those that narrowed internal income gaps (personal, regional and sectoral) during high growth, and those that faced income polarization in high growth years.
- To sustain growth to high income, three policies are needed. In principle, these can be designed and executed separately.
  (1) Industrial policy—creation of growth sources
  (2) Social policy—coping with new problems caused by high growth such as income gaps, environmental damage, internal migration, traffic and housing congestion, crime & corruption, cultural change…
  (3) Macroeconomic management under globalization—coping with global business and price shocks, huge and unstable capital flows, interest rate gyration…
- Meanwhile, "pro-poor growth" and "inclusive growth" argue that growth and equity must be integrated.

Separation of Growth and Social Policies in East Asia's Successful Latecomers



Two Groups in East Asia

Economies that had equal or equalizing income during a high growth period

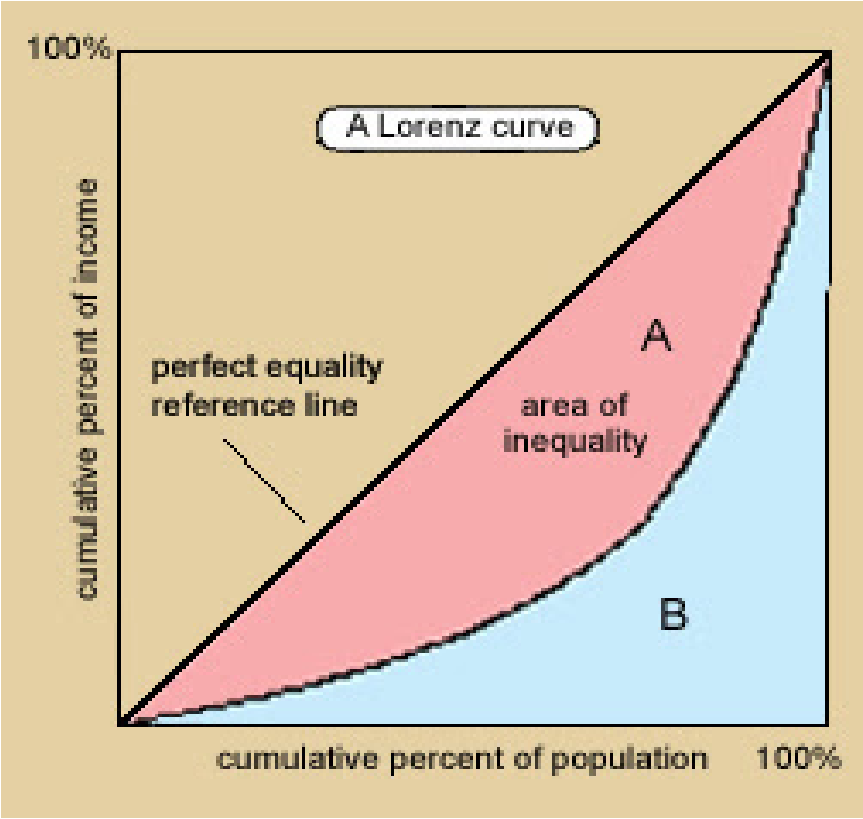
- Japan, 1950s-60s
- Korea, 1970s-80s
- Taiwan, 1960s-80s

Economies that had unequal or polarizing income during a high growth period

- China, after 1980s
- Thailand
- Philippines
- Malaysia
- Indonesia & Vietnam—beginning to be unequal

Lorenz Curve and Gini Coefficient

- A Lorenz curve shows cumulative income against population.
- The Gini coefficient measures the degree of income inequality and ranges from 0 (perfectly equal) to 1 (perfectly unequal).
- The result often depends on data and researchers.



Gini coefficient = A / (A+B)

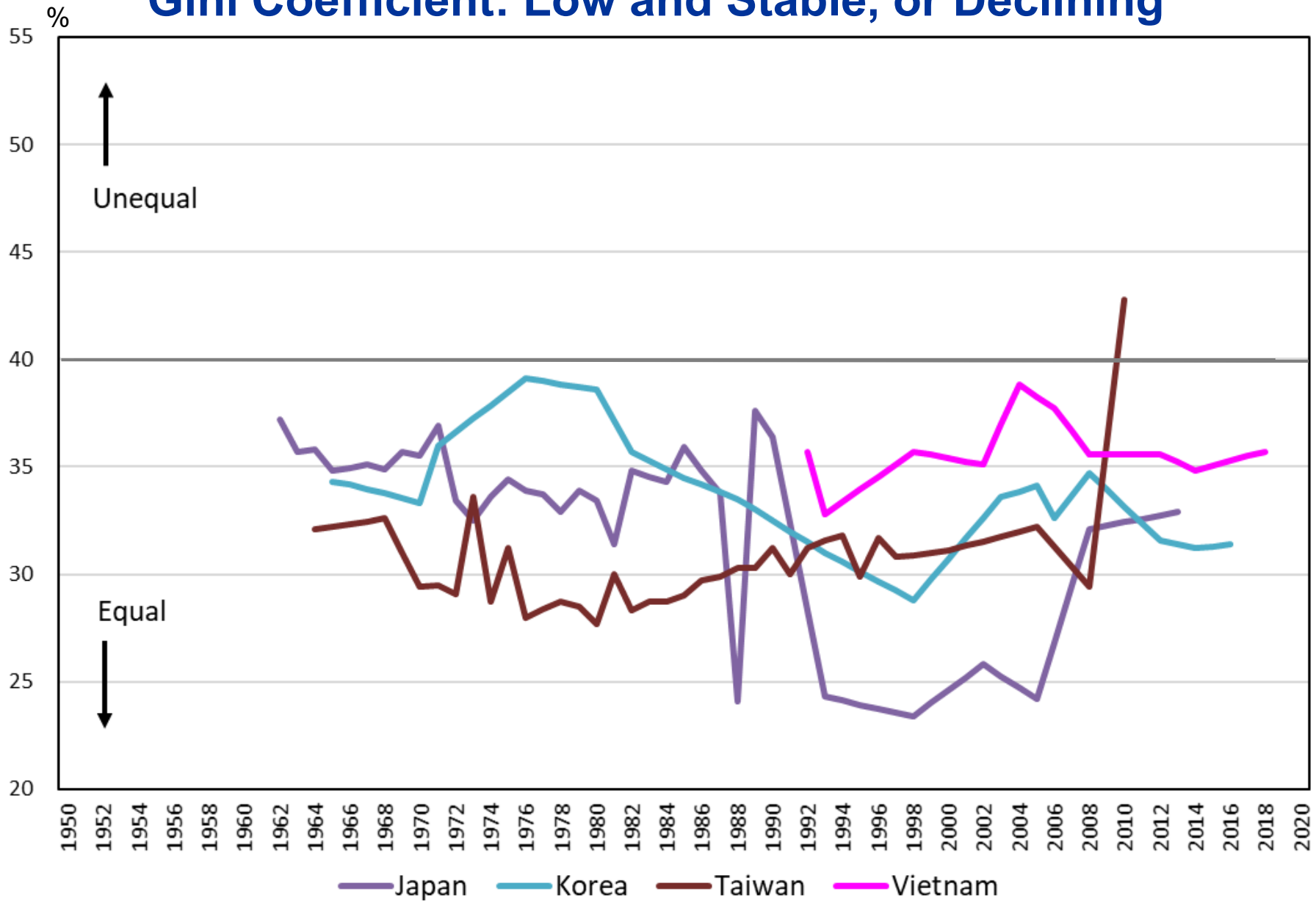
0 ➔ Everyone has the same income

1 ➔ Only one person monopolizes wealth, others have no income.

Actual numbers come in between:

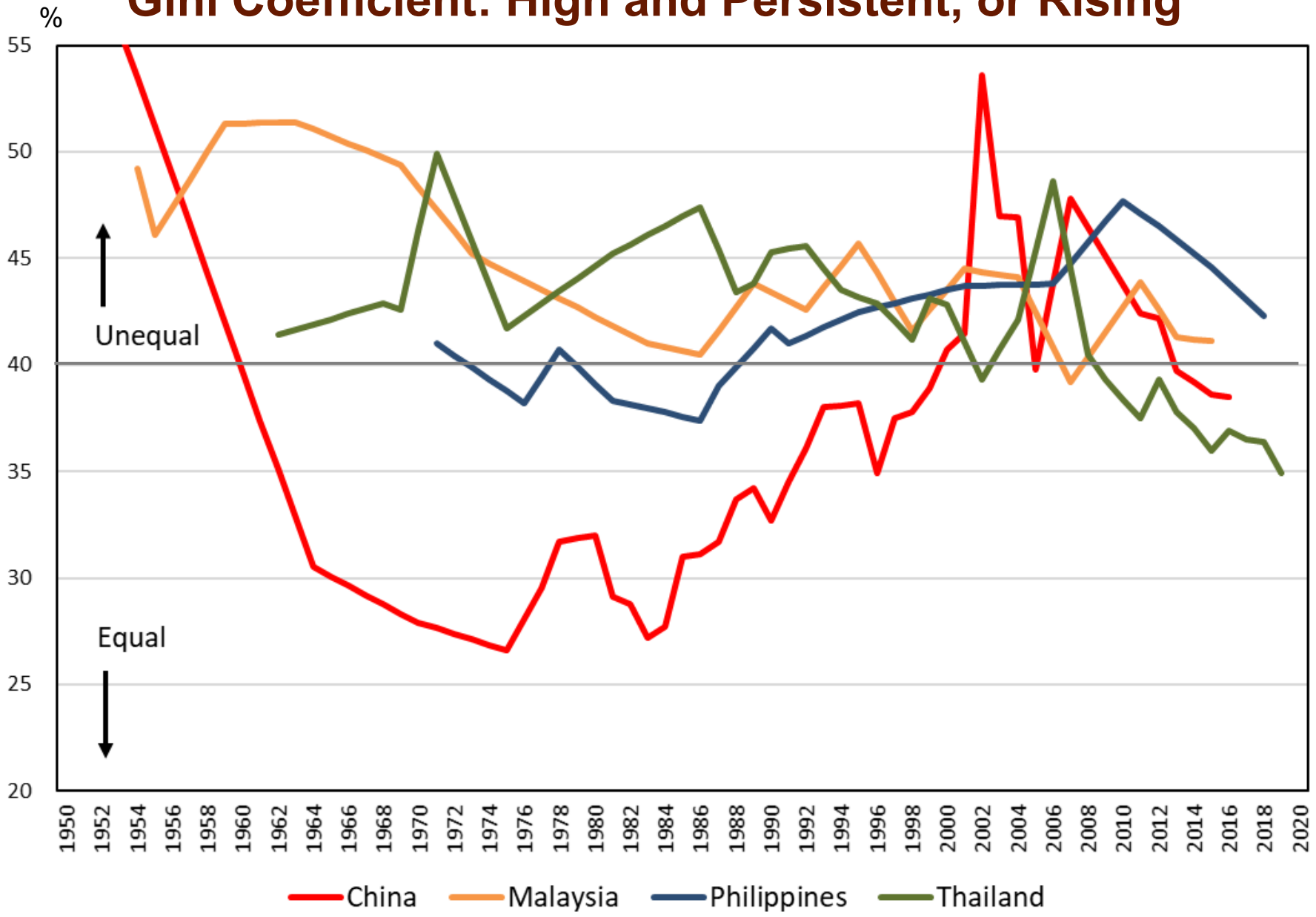
- Up to 30%: relatively equal
- 40% and above: highly unequal

Gini Coefficient: Low and Stable, or Declining



Source: World Bank, World Development Indicator, Gini coefficients (WB estimate). Accessed on July 8, 2021.

Gini Coefficient: High and Persistent, or Rising



Source: World Bank, World Development Indicator, Gini coefficients (WB estimate). Accessed on July 8, 2021.

Sharing the Fruits of Growth between Rich & Poor, Urban & Rural, Industry & Agriculture

- **Japan around 1960s**—progressive direct (income) tax for redistribution, rural-urban labor migration, SME support, fiscal policy in favor of rural areas (public investment, agro subsidy & protection, regional development plans, etc.); household Gini coef.: 0.31 (1963), 0.25 (1970)
- **Korea around 1970s**—Saemaul (New Village) Movement for invigorating and improving rural life and production; regional income gaps were narrowed and even reversed; regional Gini coef: 0.16 (1971), 0.08 (1981), 0.06 (1991)
- **Taiwan 1960s-80s**—Strong export-led growth driven by vigorous SMEs created income and job opportunities for all citizens.

Additional Topics for Discussion

- After a nation reaches high income, what policy reform is required to sustain social dynamism? Should catch-up policy be replaced by a new policy objective and system?
- Given the traditional pattern of US trade complaint, how should a strongly emerging economy—Japan then, China now—cope with US demand for opening up, selling less and buying more?
- What should be the proper economic model for a country that has (almost) achieved high income—free market, state guidance, MITI model or others?
- Discuss the difference between nations that attained income equality during high growth and those that worsened income gaps. What policies are needed?