

## BOOK REVIEWS

# Cracks in the System

By Leonard Schoppa

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### JAPAN: THE SYSTEM THAT SOURED

RICHARD KATZ

Armonk, New York: M.E. Sharpe, 1998  
463 pages. Cloth, \$68.95; paper, \$24.95

For almost 15 years, popular American writing about Japan has been dominated by noisy "Revisionists" on one side and defensive "Chrysanthemum Clubbers" on the other. The Revisionists argued that the system of government-led industrial policy perfected by Japan had propelled its postwar economic miracle and was destined to lay waste to one American industry after another unless the United States began to fight back. As recently as 1995, financial journalist Eamonn Fingleton, in his book *Blindside*, worried that the Japanese were poised to overtake the United States by the year 2000 despite the nation's economic difficulties that were already apparent at the time.

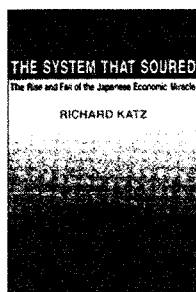
The Chrysanthemum Clubbers insisted that Japan's miracle was based on nothing more sinister than sound macroeconomic policy and hard work. They disputed claims that Japanese trade barriers were a threat to the American economy, and argued that the United States should take care of its own problems and let markets and exchange rates determine trade flows.

After almost a decade of stagnant Japanese growth that threatens to plunge further into a deflationary spiral, this debate has become increasingly irrelevant to the facts on the ground. The threat Japan poses to the U.S. economy today stems more from its weakness than its strength. Instead of

arguing over what caused the Japanese miracle, authors of books and articles on Japan ought to be telling us what brought that miracle to an end.

Richard Katz's book, *Japan: The System That Soured—The Rise and Fall of the Japanese Economic Miracle*, seeks to provide an answer to this very timely question while simultaneously explaining the economy's earlier success. In the process, he borrows ideas and insights from both the Revisionists and the Chrysanthemum Clubbers, putting an emphasis on both government industrial policy and economic fundamentals. Neither camp will be entirely happy with this book, but Katz is to be commended for succinctly laying out a new "success that soured" paradigm that explains the current economic problems in Japan better than either of the established schools of thought. This new model is destined to shift the parameters of the national debate about Japan in the United States in ways that will be more likely to resolve problems than create them.

Katz, senior editor of *The Oriental Economist Report*, argues that the same systems of government intervention in the economy and inter-firm relationships that propelled the nation's economic growth during the catch-up era prior to 1973 contributed to its much more anemic base performance in the years since that date. In the earlier period, Katz argues, government intervention that encouraged investment in future growth areas and protected key sectors from foreign competition actually helped the economy grow faster than it should have. Comparing Japan's growth



rate during the catch-up period to rates of growth found in other nations at similar stages in their economic development under similar economic conditions, Katz finds that Japan outperformed all of them, including the newly industrialized economies, such as the Republic of Korea (South Korea) and Taiwan. It grew at an annual rate of 8.4 percent, 1.4 percentage points faster than the 7 percent growth rate expected based on his econometric model. It did so, he argues, by providing infant industries such as autos with protection and by encouraging extremely high rates of investment in industries such as steel and shipbuilding. Up to this point, Katz's argument differs little from those of Chalmers Johnson and other Revisionists. Katz merely augments this view with references to more literature from the field of economics along with much more comparative economic data.

The glowing portrayal of Japanese economic success ends for Katz, however, in the year 1973. The blow delivered by the oil shocks to many sectors of the economy that year, combined with the rise of Tanaka Kakuei's political machine, he claims, began to "sour" Japan's success as protection and promotion policies that previously had propelled growth were increasingly used to keep inefficient sectors of the economy in business.

Again comparing Japan to nations at similar stages of economic development under similar conditions, Katz finds that Japan's annual growth rate of 3 percent between the years 1973 and 1990 was below the 4.3 percent growth rate expected based on his model. Japan was underperforming, in other words, even before the disastrous decade of the 1990s.

The tools that had helped produce the earlier miracle stopped working, Katz argues, because Japanese leaders failed to anticipate how ill-suited these tools were to the nation's new status as a mature economy. Protectionist trade policies provided benefits when there were plenty of

"infant industries" in need of a boost. In an economy with many mature sectors and few infants, however, the same policies and private sector arrangements contributed to a misallocation of resources in favor of slower growing sectors.

Katz writes, for example, about how cartels in sectors such as cement and steel have managed to limit imports to a narrow segment of the Japanese domestic market despite the cartels' much higher prices—protected from antitrust enforcement and cartel breakdown by what he calls a continuing insular mentality on the part of other Japanese firms. Katz criticizes Japan's lifetime employment system as well for the role it has played in generating political pressure to save declining industries.

All of these policies serve the social purpose of keeping workers in their jobs, Katz admits, but they play this role in a way that is extremely inefficient. Protection of declining domestically oriented firms raises costs of inputs for Japan's more competitive firms and drives up the value of the yen, further hurting these more productive sectors. The result is that more and more of the most competitive firms have begun to shift their production abroad. Japan is saving less-well-paying jobs of the past at the expense of better-paying jobs of the future.

Katz describes the above malady as Japan's "supply-side problem": Structures that protect inefficient sectors have limited the nation's productivity growth and deprived the economy of the ability to increase production "supply" at its potential rate.

He devotes equal attention to Japan's difficulties generating sufficient demand to absorb the supply it does produce—a problem he calls "economic anorexia." Like Japan's policy of protecting infant industries, the nation's proclivity to limit its current consumption in favor of savings and investment made sense, Katz writes, during the catch-up era when attractive investment opportunities were readily available. Once Japan reached maturity,

however, this habit of under-consuming has proven to be a major problem that helped produce the "bubble economy" of the late 1980s while aggravating the post-bubble hangover of the 1990s.

The greatest strength of *Japan: The System That Sourred* is its ability to describe in language accessible to non-economists how both the supply- and demand-side problems have contributed to Japan's economic difficulties in the 1990s. Katz makes it clear that any proposed solution that deals with just one of the two maladies will likely fail to solve the problem.

Unfortunately, Katz declines to spell out in detail what Japan needs to do. He calls for the "wholesale modernization" of Japan's political, corporate, financial and trading institutions and in his concluding chapter discusses where these various projects stand today, but he does not lay out a specific action plan of his own.

Based on his reading of the problem, though, the essential elements of such a plan are quite apparent. First, Japan needs to adopt structural reforms. It needs to eliminate regulations that limit competition and protect inefficient sectors, and to enforce its antitrust policies with the vigor required to root out entrenched anticompetitive practices. Business practices that get in the way of adjustment, such as lifetime employment, long-term commitments to suppliers, and the provision of loans and other financing based on long-term relationships rather than hard-nosed financial analysis need to be eliminated.

Second, all of this needs to be done with the conscious aim of increasing the penetration of goods and services made and provided by foreign firms. Higher levels of imports will force the entire economy to become more efficient. This adjustment will be accompanied by a decline in employment as inefficient sectors down-

size, but this loss of jobs should be more than offset in time by new employment in expanding export-oriented sectors. As the nation's "web of mutual support" unravels, Japan needs to adopt western European-style welfare state institutions to provide social protection for dislocated workers.

Finally, Japan needs to address its problem of economic anorexia by adopting policies that stimulate consumption such as a mortgage interest deduction on housing loans as well as broader tax cuts and fiscal stimulus packages in the short term to jump-start growth. Katz also suggests that lower prices brought on by structural reforms will stimulate consumption.

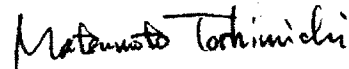
The main problem with Katz's analysis of Japan's economic problems and with the course of action it suggests is that it does not adequately take into account the degree to which efforts by Japan to fix either one of his two problems is likely in the short term to aggravate the other one. Structural reform on the scale Katz recommends—including an end to lifetime employment—is likely to aggravate the nation's problem of inadequate demand as worried families cut back on their spending. Demand stimulus similarly risks artificially sustaining inefficient sectors and relieving market pressures driving structural adjustment.

The challenge for Japanese leaders is to figure out a way to address the two urgent economic problems Katz identifies in a way that minimizes the inevitable negative spillovers. A reform package that calls for the nation to preserve and build on what is best of the Japanese economic system while boldly attacking those features that have contributed most to inefficiency, such as cartels and regulatory limits on competition, would probably aggravate Japan's economic anorexia less than a decision to embrace economic orthodoxy in the blunt terms Katz recommends.

## The Eurasian Relationship

In his "Japan's Eurasian Diplomacy: New Perspective in Foreign Policy," Foreign Minister Kôamura Masahiko elucidates the course of Japanese diplomacy in the coming century. Close cooperation with the United States, Japan's strongest partner, will surely remain central to foreign policy. By virtue of its position in East Asia and at the western edge of the Pacific, Japan has a vested interest in enhancing peace and prosperity among its Pacific Rim neighbors in concert with policy coordination with Washington. And now Kôamura, as the senior elected official responsible for executing Japan's diplomacy, discusses, although in a guarded tone, how this new challenge of building stronger ties with Eurasian nations—especially Russia, China and neighboring nations—will be addressed.

It is often said that Japanese are especially sensitive about how they are seen abroad. I agree. Ôtake Hideko, a free-lance editor and writer living in New York, states in her "Japanese Reflections in an American Mirror" that she is among those who often find a wide gap between what Japanese believe themselves to be and the way they are portrayed in U.S. media. In her article, she discusses the difficulties journalists encounter in establishing mutual understanding between cultures and expressing it in their reportage. We believe it is inevitable that there will be diverse views, if not disagreement, regarding the points she raises. We encourage readers to respond, and we hope *Japan Quarterly* will be a forum for advancing the insights on the issue.



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