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THE JAPANESE SLUMP

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Abstract

This paper examines the Japanese slump through the respecive macroeconomic spectacles of Hayek and Keynes, and shows that the decade old slump is Hayekian in nature, and its cure is hampered both by the high yen policy misguidedly thrust on Japan by the US as well the peculiarities of Japanese political economy.

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I am delighted to be able to contribute to honour Horst Siebert on his 65th birthday. As director of the Kiel Institute of World Economics, he has continued the classical liberal tradition which his predecessor Herbert Giersch did so much to refurbish, by not least having it's voice heard in the highest echelons of German policy making, as one of the 'wise men' from the country's leading economic research institutes advising the German government on economic policy. As such I thought it would be fitting in a festschrift for him to revisit the 1930's debates between Hayek and Keynes on the macroeconomy as reflected through the prism of the ongoing (as I write in early 2002) Japanese slump.

In the first section of the paper I set out the reasons for maintaining that the Japanese are in a Hayekian rather than Keyensian slump. In the second I examine the relevant international factors- in particular the 'high yen' policy thrust upon Japan by the USA - in generating the slump. In the final section I examine the unique political economy of post Meiji Japan, including its much touted 'Asian model' of development, which I argue are largely responsible for Japan's failure to recover to date (January 2002).

I
Keynes vs. Hayek

The continuing Japanese slump provides one of the rare natural experiments which can help us to distinguish between alternative economic theories. It is now not well-known that, apart from Keynes, the most renowned macroeconomic theorist in the inter-war years was Friedreich Hayek. Though he is currently best known for his robust defense of a refurbished classical liberalism, he originally made his name, followed by a chair at the London School of Economics, as a leading proponent of the Austrian school's theory of the trade cycle. It was this work culminating in his "Monetary Theory and the Trade Cycle", "Prices of Production" and "The Pure Theory of Capital" which was cited as the reason for his Nobel Prize in 1974.

Hayek was a robust critic of Keynes' views, who after writing a critique of "A Treatise' of Money" did not bother to take on Keynes' "General Theory..", because he thought it was not worth it, as Keynes as usual "would change his mind". (see Hayek (1994). This was a pity. For Keynes' theory won virtually by default, and was not dethroned until Robert Lucas' "new classical" macroeconomics based on one of Hayek's major insights -concerning the division of knowledge in an economy- was transformed into 'rational expectations', which ended the Age of Keynes.

The Great Depression was supposed to have been cured by the wartime fiscal stimulus - a Keyensian prescription- and taken to be an empirical validation of Keynesianism, and Hayek's views were forgotten- as was he- for nearly three decades. But now that the Japanese government after a decade long slump has failed, with one Keynesian fiscal stimulus package after another, to move the economy, perhaps, it is time to revive the Hayekian perspective.

Hayek like the Austrians had argued that capital theory and monetary theory needed to be integrated. This was to be done by emphasizing the crucial role of the system of intertemporal prices, in particular the level and structure of interest rates in the economy. Central in understanding this structure and the false signals given by misguided monetary policy was his notion of 'neutral money'. Following from the quantity theory of money- which Hayek emphasized is broadly valid- he argued that, the traditional view that money was neutral as long as the value of money (ie. the level of prices) was unchanged- for instance with money increasing in proportion to increases in output- was based on assuming an absence of 'injection effects', that is the distortionary effects of how the money supply is increased. If the injection of money is through the credit markets, then even if the total ensuing increase in the money supply is proportionate to the increase in economic activity- so that there is no inflation- the changes in interest rates induced by the expansion of credit could lead to false signals in the pattern of intertemporal prices and thence to a misallocation of resources.

For changes in the interest rate will have a systematic effect on the pattern of prices which allocate resources among different stages of production. In modern terminology, a fall in the interest rate due to credit expansion will lead to investment projects- which are relatively more capital intensive- with lower ex ante rates of return being undertaken. The artificially low rate of interest induced by injecting money through credit expansion will lead to an unsustainable boom as more investment projects are undertaken than can be completed. As the accompanying resource scarcities emerge, the boom will turn into a bust. The economy will only recover once the 'malinvestments' are liquidated and resources reallocated in line with intertemporal consumer preferences and resource availabilities.

Thus, writing in 1925 just before the Great Depression (see chp.1 in Hayek (1984)) he noted that, during the prosperous decade of the 1920's though the overall US money supply had increased pari passu with output so that there was no inflation, but, as the money had been injected through credit markets the resulting misallocation of resources caused by the credit boom would lead to a bust. Whether Hayek was right or wrong about the Great Depression cannot now be disentangled, as witness the continuing debates on its causes as well as of the subsequent recovery. But we can now at least look at the laboratory experiment of Japan.

The basic facts are well known. After a credit induced bubble in equity and land markets in the late 1980's, the Japanese economy slumped during the 1990's- despite repeated fiscal injections a la Keynes. Nominal interest rates have been reduced to virtually nil, but with the price deflation accompanying the slump, real interest rates remain positive and can not be further reduced by cuts in nominal rates. So it appears on the surface that, Japan is in a Keynesian liquidity trap. The modern Keyensians, as represented by Paul Krugman (1998), recognizing the abject failure of the traditional Keyensian panacea of fiscal deficits to cure the Japanese slump are now arguing for a credible "irresponsible" policy of generating inflation of 4 per cent per annum for the next 10-15 years to move Japan out of its liquidity trap.

However, an empirical exercise by Tamim Bayoumi (2001) finds that, rather than a shrinking of the money supply, it is the role of "financial intermediation in magnifying the impact of asset prices on the economy" during the 1980's boom and the reverse disintermediation process once the asset bubble collapsed which explains the continuing slump. This is similar to Peter Temin's (1976) findings for the Great Depression. Money does matter but not as much as the credit cycle. This is very much in line with the Hayekian credit expansion induced boom and bust story.

Further validation for the Hayekian view- about the real consequences of the false signals to intertemporal pricing caused by artificial credit expansion- is provided by some detailed work on the Japanese national accounts done by Albert Ando (2000). He finds that, the cumulated net savings of the Japanese household sector (at 1990 prices) between 1970 and 1998 was 1,250 trillion yen. The change in net worth for this sector during the same period was 860.7 trillion yen. Thus the Japanese "household sector suffered a real capital loss of 389 trillion"! Roughly three-fourths of this huge capital loss is attributable to the loss of market value by Japanese corporations. Over this period they "managed to incur real capital losses of 405.5 trillion in their market value". How did this happen? Working out the rates of return of non-financial corporations and both for them and financial corporations for 1996, he finds that the returns were just above 2% for the former and 1.6% for the latter.

These low returns are due to Japanese corporations having "over-invested in plant and equipment using funds retained through a very high rate of depreciation and the large savings channelled through financial institutions." This has led to very high capital output ratios- which have continued to rise during the depressed 90's- and very low rates of return. Thus, as Ando notes, the Krugman prescription based on the assumption that Japan is in a liquidity trap is untenable, as "the liquidity trap presupposes a very low level of investment as the basic cause of the recession. In Japan, on the other hand, investment by corporations appears to be too large if anything, and it is the deficiency of spending by households that is the basic problem." And why is spending by households deficient- or in other words savings so high in Japan? If any ageing population found that it had lost 31% of its lifetime savings over 30 years, it would hardly be surprising if they had to continue to save rather than spend to see them trough their old age! So, it would be fair to conclude that, it is not a Keyensian liquidity trap but Hayekian malinvestment which is the core of the Japanese problem. As such Japan needs Krugman's advice as it needs a hole in the head!

But many of these aspects of the real economy of Japan are of long standing, and though there is a presumption that Hayek rather than Keynes provides the explanation for the Japanese slump, some other factors need to be brought in, to show why the boom and bust happened when they did, and what the Japanese government can do for economic recovery.

II
The Role of the high Yen

The unsustainable credit boom of the late 1980's led, as Hayek predicted, to 'malinvestments' as the artificially lowered interest rate promoted capital intensive and low return investment. The rate of return to capital fell from an average of about 12% in 1952-73 (the golden period of Japanese growth) to between 1.6-2% in 1996. This growing inefficiency in capital use is an unintended consequence of the much touted 'Asian' model of development- on which more in the next part. What still needs to be explained is the timing of the boom and bust in Japan. An excellent study by Ronald Mckinnon and Kenichi Ohno (1997) provides the answer.

The clue to the timing and continuation of the slump is provided, in their view, by an explanation the Japanese themselves give for their troubles. They label it endaka fukyo meaning a high yen recession. This in turn is due to what Mckinnon and Ohno call the 'high yen syndrome' which is a reflection of the continuing trade frictions between the US and Japan. Ever since President Nixon closed the 'gold window' and the world entered a regime of floating exchange rates, the US has constantly attempted to tackle its chronic trade deficit with Japan by putting pressure on Japan to maintain a high and rising yen relative to the dollar. The institution of actual and threatened action against Japanese exports, culminating in the notorious Super 300 legislation, has forced Japan to comply. The Bank of Japan (BOJ) delivered the requisite appreciation through tight domestic monetary policies.

With the opening of the Japanese capital market in the early 1980's, Japanese interest rates were thereafter tied to those in the US, but with a built in expectation of a continuing yen appreciation because of the persistent US trade pressure on Japan. For Japan acquiesced in a rising yen as a lesser evil than a trade war with the US. This meant that, Japanese interest rates would be lower than US ones by the expected rate of yen appreciation. While US interest rates were high, this still meant that nominal Japanese interest rates though lower than US ones were still positive, allowing the BOJ to moderate the effect of yen appreciation through an easing of domestic monetary policy.

After the Plaza and Louvre accords in the 1980's there was a massive appreciation of the yen which led to a Japanese recession in 1985-86, and a lowering of nominal Japanese interest rates to close to zero. As in the more recent endaka fukyo this meant that the BOJ could not counter the 1985-86 'high yen' generated recession by any further lowering of nominal interest rates. However, the fall in interest rates and the liberalization of the Japanese capital market meant that, even with the worsened prospects of the tradeable sector due to the high yen, the capitalised value of future income streams- particularly of land- soared, as the interest rate at which they were discounted, fell. This was the start of the great Japanese asset bubble. The rise in asset values allowed domestic demand to replace foreign demand for Japanese output (which had fallen due to the high yen) as the engine of growth in the Japanese economy, and Japan rapidly grew out of the recession.

The BOJ hailed this escape from the deflation forced by the high yen, and became the primary cheerleader of the growing asset bubble. It praised 'the new economy' in which domestic demand fuelled by the rise in asset prices led to growth, while giving time to the tradeable sector to adjust to the higher yen. The Japanese government was happy with this outcome, as it meant that, having got its fiscal house in order after the fiscal looseness following the oil price shocks of the 1970's, it did not have to run Keynesian type fiscal deficits to deal with the endaka fukyo of 1985-86.

But bubbles burst, not least because in the late 1980's, the BOJ- worried about the massive appreciation in land and stock prices- sought to prick the bubble by tightening monetary policy. This, of course, precipitated another recession, which was accompanied by another massive yen appreciation- again prompted by growing trade friction with the US. It was only in 1995-96 that the US eased this pressure and allowed the yen to depreciate against the dollar. That immediately led to the end of the first 1990's depression, but only temporarily, as subsequently the usual trade friction and the pressure for yen appreciation reemerged, and Japan was plunged into its second endaka fukyo of the 1990's from which it has still to emerge.

The successive Keynesian packages have not worked, and the massive public debt that Japan has created in the process, presage a serious fiscal crisis in the future, particularly in view of the growing demands for public expenditure on pensions and health care for a rapidly ageing population. With the bursting of the asset bubble there is no hope for an escape from the ongoing recession through the asset inflation route of the 1980's. The bursting of the asset bubble has also led to the virtual insolvency of most of the domestic financial system. So, apart from the need to clear up this financial mess- on which more anon- the future economic prospects of Japan also depend upon the US giving up its demand for a continuing high yen.

The great irony is that, an appreciating yen is a completely misguided remedy for curing the structural trade imbalance between the US and Japan. Modern balance of payments theory tells us that, in a world of integrated world capital markets and floating exchange rates, trade deficits are the result of the difference between domestic investment and savings. If one country saves less than it invests- as has been true of the US over the last two decades- and the other does the reverse, then a trade deficit in the borrowing and trade surplus in the lending country is as inevitable as night follows the day. The Japanese trade surplus is nearly the same size as the deployment of its savings in the US. As long as the US has to rely on Japanese savings to fuel its domestic investment, it will necessarily have to run a trade deficit with Japan. No appreciation of the yen can prevent that.

Moreover, with the bursting of the Japanese asset bubble in 1990-91, Japanese investors reigned in their investments. The resulting fall in capital inflows into the US led to a credit crunch and the mild recession which torpedoed the re-election hopes of President Bush. While the resumption of foreign lending by Japanese investors in the 1990's, because of the pitiful domestic returns available, fuelled the massive investment boom which has led to the 'new economy' miracle of the Clinton era.

But the poor Japanese investors have hardly benefitted from this foreign deployment of their savings. Though Japan is now the world's largest creditor nation and the US the biggest debtor, Japan's foreign trade and capital flows are still largely denominated in dollars. Thus unlike past creditor nations- Great Britain in the 19th century and the US for most of the 20th- whose currencies were the world currency in which their loans were denominated and hence did not have to bear any currency risk involved in foreign lending, the Japanese have borne this currency risk. This means that, with the dollar depreciating against the yen, their returns on foreign investments have been virtually wiped out over the 1980-90's. With the returns on their domestic investments having been virtually extinguished by domestic malinvestment, and those on their foreign investments by the appreciating yen, one cannot but feel sorry for those unfortunate ageing Japanese who through their frugality have bailed out the world economy- and the US in particular- over the last two decades, but find they have received no rewards. At some stage they are likely to turn against the political and economic system- as they are beginning to- which has served them so ill. I turn to these political economy aspects of the continuing Japanese slump.

III
The Political Black Hole

If the Japanese slump is Hayekian in nature, then to restore economic health ,it will be necessary to work out the 'malinvestments' which lie at its core. This means not only liquidating those with low returns but also clearing up their financial counterpart represented by the mountain of bad paper in the financial system. If some estimates of the size of this problem are correct , then there is a serious political problem which faces those involved in clearing up this mess. As the example of the US savings and loan debacle, and the more recent Korean and Thai financial crises show, with sufficient political will this can be done. But the size of the write off in these cases though large was not as massive as that in Japan. Thus, in 1999 (at a private dinner) Paul Volcker- the former Chairman of the US Federal Reserve- guessed it was over 100 % of GDP. It is a brave politician who can openly state that more than a year's GDP has just been lost! Not surprisingly Japanese politicians have been skirting around the problem like headless chickens. Nor have they been helped by the nature of the political system that was created after the Meiji restoration, which despite the new clothes provided by the post Second World War constitution, has survived to our day. 3/

Historically, unlike China which for centuries had a unified authoritarian bureaucratic imperial state, Japan (since the Taika reforms of 604 AD) has evolved a unique form of dual and at times triple government. The 17 Articles of the Constitution, instituted as part of these reforms, in effect created a constitutional monarchy in all but name, with political power being wielded by shoguns, or prime ministers or chief advisors backed by military power. This led to the long line of emperors who were politically neutered while being made sacred and inviolable. This unbroken, divine imperial house has provided the focus for Japanese loyalties and nationalism to our day.

Though Confucian in their origins, unlike their Chinese counterparts- who were skilled in the arts and literary classics and were stolidly opposed to Western science- the warrior bureaucracy of Japan was interested in weaponry and thence science and technology. From the Tokugawa Bakufu to the Meiji reformers, they were enthusiastic about acquiring Western science but without disturbing the cherished Japanese values of loyalty, filial piety and duty to one's elders, which regulated the hierarchic social relationships based on authority, blood ties and age.

Thus, when Commodore Perry's ships appeared across the horizon, the Meiji oligarchs speedily sought to adopt Western technology and institutions, but also at the same time to inoculate curious Japanese minds against subversive foreign ideas such as individualism, liberalism and democracy. A 'national identity' was invented, allowing power to be explained and justified in new ways that enabled new methods of control to be introduced. This ideology of the "family state" was set out in the Imperial Rescript of Soldiers and Sailors of 1882 and spread through military conscription and indoctrination in the national educational system.

At the same time the Meiji oligarchs created a political system in which there is no single focus of effective political power. This reflected their reluctance to write a constitution in which power could be concentrated in the hands of a leader legitimized by the emperor, in as much as this would have threatened the position of some of them and the oligarchy would have disintegrated. So an uncertain sharing of responsibility was preferred with no identifiable person bearing the ultimate responsibility for decisions. As the events leading to the second world war showed, this had the danger of developing into a colossal system of irresponsibility.

The Meiji oligarchs also propagandized that politicians being concerned with narrow party and personal self-interest were unpatriotic. With politicians not being able to exercise power, another group had to be found to manage the country. This was the meritocratic bureaucracy created in the early days of the Meiji revolution. One of the oligarchs, Yamagata Aritomo, made it immune to political meddling by obtaining a personal communication from the emperor which could never be overruled, and which made the Privy Council the guardian of edicts drafted by Aritomo concerning examinations, appointments, discipline, dismissal and rankings of bureaucrats. Since then bureaucrats largely recruited from the Law department of Tokyo University (Todai) 2/ have in effect governed Japan.

But this has not led to the creation of an "administrative state" as in France. This is because of the loyalties inculcated in Japan to concentric ingroups- from the family to the firm and the nation.(see Eisenstadt (1996)) While behaviour between ingroups is based on status differentials and deference, between different ingroups there is fierce competition, with behaviour to outgroups being quite brutal- as witness the pushing and shoving so common on Japanese underground trains. The negative emotions suppressed within ingroups are openly expressed towards outgroups, which are only tempered if there is a possibility of future harmonious relationships. Hence the apocryphal story of how someone pushing and shoving a fellow passenger to get into the train, stopped dead in his tracks when the passenger being shoved turned and looked at his attacker and said : "I know you"! Translated to the bureaucracy, these social attitudes have led to it being riven with internal strife, with each intra or inter-ministerial bureau trying to preserve or expand its turf. With no political overlord to settle or adjudicate these bureaucratic disputes, decisions could only be made by 'consensus'- which in many cases was just a polite word for paralysis. This political system- in particular the bureaucrats- survived the post-war purges and the imposition of an American drafted constitution. The system the Meiji bureaucrats dreamed of has been recreated. Its effective lack of a political center to adjudicate disputes continues to haunt Japan in its current predicament.

How then, did this political black hole deliver the Japanese miracle? It clearly could not have been- as so many Western commentators have suggested- because of the enlightened dirigisme of a developmental state. In fact, as the detailed comparative growth experience of the OECD countries by Maurice Scott (1989) shows, there was no miracle. The 9.2% p.a growth rate from 1960-73 during these 'miracle' years (as the growth rate fell to 3.8%p.a from 1973-85) can be explained entirely by the investment rate, the growth in the quality adjusted labour force and a catchup variable.

In fact, the much touted Asian model of development- which combined an unholy alliance between parts of the government, large industries and the banking system- stored up the troubles which have led to the continuing slump. Because of the moral hazard created in such an economic system (see Lal (2000)) the financial system comes to be stuffed with more and more bad paper, as industrialists over invest and undertake increasingly dicey investments. The bursting of the 1980's asset bubble has merely brought these chickens home to roost. What Japan needs is action to not merely clean up the ensuing financial mess but to turn its back on this doomed model.

Also Japan needs to learn to say "No" to the US and its continuing misdiagnosis of the US-Japan trade imbalance which has led to the 'appreciating yen' syndrome. But given the trauma of its second world war defeat, and its failure- unlike Germany- to come to terms with this past, it has retreated into a pacifist daydream, where the Big Brother will continue to provide the defensive shield. This undoubtedly has helped its economy in the past, as it has remain unburdened by a large defense budget. But Japan's continuing dependency - more emotional than economic- means that it has not been able to act in its own self-interest. Increasingly Japanese voices- such as Akito Morita's- are recognizing that this unreflecting dependence must end.

But, given the institutional paralysis built into its political system, who is to undertake this task? Thus, I fear there is likely to be continuing pain for that generation of ordinary Japanese, who through their thrift and productivity saw Japan rise like a phoenix from its wartime destruction, only to see as they aged, their hopes along with their savings turning to ashes.

NOTES

1. This paper is based in part on my three articles in Business Standard, New Delhi, June- August, 2001.

2. This predominance of Todai arose because it had been launched to meet the desperate need to create a competent judiciary which would end the deeply resented extraterritoriality clauses of the unequal treaties Japan was forced to sign on its opening. Its graduates did not have to pass civil service exams initially, and by 1890 their supply was large enough to fill nearly all administrative and half the judicial vacancies. (see van Wolfren, 1989,p.308).

3. The following analysis of the Japanese political and social system is from Lal (1998), based on Eisenstadt (1996), Gluck (1985), Morishima (1982), van Wolfren (1989 and Waswo (1996).

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