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Introduction

In retrospect, the most dramatic turning point in the half-century of Japan's postwar economic development was the collapse of the property and stock market in 1990. The collapse ushered in a very long period of recession lasting from 1990 to 2002, known as the "lost decade". Japanese economy experienced average annual real growth of 0.8% from 1991 to 2001.[1] One would expect that with fiscal stimuli, the economy would recover as in a normal business cycle. But somehow the recovery simply refused to show up. Conventional wisdom of economic stimulation does not tally with the Japanese experience of the long recession. The "lost decade" has acquired such an iconic status that economists have evoked it as a possible prospect of the current recession for the USA.[2]

Indeed, as the second largest economy in the world and operating in an electoral democratic framework, its experiences may shed some light on the nature of recession of an advanced industrial economy in the context of globalization, as well as the limitations of monetary and fiscal stimuli to deal with such a recession.

There are three reasons for us to study Japan's experiences for insights. First, America's and the UK's troubles are in some deep sense similar to Japan's. They are a result of a real estate bubble and easy credit. The prices of resident property in ten largest cities of the USA doubled in five years, just like those in Japan's big cities during the bubble period.[3] What is more disturbing is that nationwide, prices of resident units and commercial property in the US and the UK shot up more than they did in Japan. Second, Japan shares the essential features of an advanced industrial economy with Western Europe and the USA. The "lost decade" is likely to hold lessons for them. Third, the Japanese trajectory of economic development has offered

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1 Mitsuhiro Fukao (2003), Financial sector profitability and double gearing, in Magnus Blomström *et al.*

2 Are there any signs of recovery? BBC News, 16th April 2009 http://news.bbc.co.uk/2/hi/business/8000062.stm

3 Worse than Japan? *The Economist*, 14th February 2009.

very useful concepts for other Asian countries to consider. This pattern is captured metaphorically in the "flying geese" model.[4]

Brilliance before Bubble

The magic of Japanese economic miracle for half a century lies in a simple yet crucial fact. It was able to produce goods in high demand in a global economic order that favours free trade. Japan in the 1950s was well known for its cheap plastic toys. In the 1960s, its light Honda motorbikes appeared in big numbers in towns and cities in Asia. It manufactured small and fuel efficient cars, and against the backdrop of 1973 and 1979 oil crises, they had special appeal. Not surprisingly, the cars were enthusiastically endorsed by taxi drivers in many countries. And by 1980s "made-in-Japan" conjured up images of consumer electronics of the highest quality. In the second half of the 1980s, Japan had above-trend growth and very low inflation, and Japanese banks were considered among the strongest in the world.[5]

Between 1950 and 1973, the Japanese economy doubled in size every seven years, and it had achieved one of the highest standards of living in the world.[6] In the four decades prior to the bubble in 1990, Japan stole the show in economic development. It had the world's highest saving rates and displayed an endless and amazing capacity to adapt to the latest industrial technology. Japanese manufacturing became legendary. It emerged pretty unscathed from the OPEC oil price shock in 1973 and in its wake a large inflationary spurt. After the 1970s, the technological strengths of Japan's machinery and other manufacturing industries continued to prop up the economy, using exports as a lever. This strength was based on the innovative capacity of its technological firms.[7] They entered and successfully competed in high-tech terrains which were previously the preserve of US and European multinationals. Their prowess measured in terms of patents and productivity was the result of systematic and continuous investment in Research and Development (R & D). A study of the US Academy of Engineering published in 1987 observed that Japan was superior to the USA in 25 of 34 critical technologies.[8] To make the story more complete, we must also mention that Japan spent much less of its taxpayers' money on defence compared to other rich countries and could therefore single-mindedly

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4 Kename Akamatsu (1962), A historical pattern of economic growth in developing countries. *Journal of Developing Economies*, 1(1):3-25, March-August. Edith Terry (2002), *How Asia got Rich – Japan, China, and the Asian Miracle.* Armonk, New York: M.E. Sharp Publishing. Terutomo Ozawa (2005), *Institutions, Industrial Upgrading, and Economic Performance in Japan – The 'Flying-Geese Paradigm of Catch-up Growth.* Northampton, Massachusetts: Edward Elgar Publishing.

5 Rameshwar Tandon (2005), *The Japanese economy and the way forward,* New York: Palgrave Macmillan.

6 Magnus Blomström, Byron Gangnes and Sumner la Croix edited (2001), *Japan's new economy,* Oxford: Oxford University Press.

7 Hiroshi Yoshikawa (2001), *Japan's lost decade,* Tokyo: The International House of Japan.

8 National Academy of Engineering (1987) Strengthening U.S. engineering through international cooperation: some recommendations for action, Washington, DC: National Academy Press.

pump the money into promoting economic growth. For that it had to be grateful to America as its closest ally who provided the defence umbrella.

The 1970s and 1980s were brilliant decades for Japan when the Japanese economy attracted much fear and admiration. As the economy expanded, the R & D expenditure steadily increased. Japanese firms were able to apply the results of their R & D efforts to make useful products. It has also been noted that Japanese firms were able to produce more patent applications per R & D dollar spent than their US counterparts. However, there was a slowdown in the growth of R & D productivity in the 1990s, though this slowdown does not affect all firms equally. The electronics industry has shown continuing research productivity, in line with the trends of the 1980s and early 1990s. The star performance has spurred many studies and inspired the appearance of books like *Japan as Number One* by Ezra Vogel in 1979 and *The Enigma of Japanese Power* by Karel van Wolferen in 1989.

Background to the "Lost Decade"

As the US economy gained steam in 1983-5 and the dollar surged in value, US import from Japan rose dramatically. Japan was under pressure to reduce its trade surplus with the US by appreciating the yen/dollar exchange rates. Partly as a result of the Plaza Accord in September 1985 and subsequent central bank intervention and partly market forces, the Japanese yen rose rapidly. The result was a shock to the Japanese economy and the "high yen slump".[9] To halt further yen appreciation, Japanese monetary policy shifted toward a more expansionary stance. Between 1985 and 1987, the Bank of Japan discount rate was cut from 5% to 2.5%, and it remained at this level through 1989. At the same time, Japan embarked on a program of financial liberalization, partly in response to pressure for more open competitive markets. The move spurred price competition among financial firms and prompted them to take greater risks.[10]

The combination of financial liberalization and monetary expansion is generally blamed for creating asset price inflation in the second half of the 1980s. To cope with a mild slowdown in economic and employment growth, the government poured huge sums to stimulate the economy, most of them in public works projects, and ran up large budget deficits.[11] At the same time, financial liberalization had allowed major manufacturing firms to bypass banks in raising investment funds, and banks had consequently lost some of their best business. They responded by turning their attention to real estate and stock lending. First stock and then land prices rose dramatically after 1986, more or less doubling in value over several years. The rapid rise in wealth-stimulated consumption spending helped to close a large portion of the trade surplus by the end of the decade. At the peak of its bull market, the value of land

[9] Ryuichiro Tachi (1993), *The contemporary Japanese economy – an overview* Tokyo: University of Tokyo Press.

[10] Rameshwar Tandon (2005), *The Japanese economy and the way forward,* New York: Palgrave Macmillan.

[11] Ryuichiro Tachi (1993), *The contemporary Japanese economy – an overview* Tokyo: University of Tokyo Press. Peter Drucker (1998), In defense of Japanese bureaucracy, *Foreign Affairs* Sept-Oct vol. 77, no. 5, pp. 68-80.

in Tokyo exceeded that of the state of California, and the total value of land in Japan was four times that of the United States.[12] It is useful to bear in mind here that the area of California is bigger than the area of Japan. This gives us an idea of the size of the bubble.

In the period of euphoria, the quality of debt deteriorates.[13] The low quality and over extended loan portfolios left Japanese financial and non-financial firms exposed to considerable risk. When monetary policy was tightened in 1989 and 1990, stock and land prices quickly shed most of their gains of the previous four years.

The collapse of the stock market and property market was not surprising. What was surprising was that the recession dragged on for so long in spite of massive prime pumping. For example, between 1992 and 1995, there were five fiscal stimulus packages, totaling 54 trillion yen.[14] As a result of the series of fiscal stimuli, Japan's public debt is huge. It was 836 trillion yen at the end of June 2007, according to the Ministry of Finance. Its public-debt ratio stood at 65% of GDP in 1990, ballooned to 175.5% in 2006 and to about 180% in 2009.[15] Even after a series of fiscal stimuli, there was no sustainable recovery.

Many Japanese firms and banks entered the 1990s with a heavy debt burden left over from the bubble years. Some banks went under and a number of them merged. Many manufacturing firms had substantial excess capacity after the investment boom of the 1980s. It takes time for the firms to pay back the loans and to work away the excess production capacity. These are two clear attributes of a weak economy. As a result, Japan has not been able to restore stability to its financial sector since 1990. Fixing the financial system cannot be achieved simply by continuously pumping cash into the commercial banks. To get off the life support system, banks must restructure themselves so that they earn normal profits and function as value-adding financial intermediaries again.

Two Approaches to Get Japan out of Recession

Conventional wisdom prescribes the aggressive use of fiscal and monetary expansion to stave off a recession. Based on its successful track record in dealing with recession in many countries over several decades, Keynesian economics argues that insufficient demand is the cause of the recession. Except for the chaotic period just after the Second World War, Japan's post-war recessions are caused by a shortage

[12] Kochi Hamada (1995), Bubbles, busts and bailouts, in Mitsuaki Okabe edited, *The structure of Japanese economy,* London: Macmillan, pp. 263-286.

[13] Charles Kindleberger (1978), *Manias, Panics, and Crashes: A History of Financial Crisis,* New York: Basic Books.

[14] W McKibbin (1996), The macroeconomic experience of Japan since 1990: an empirical investigation, Research School of Pacific and Asian Studies, Australian National University, quoted in Magnus Blomström et al (2001).

[15] Japan's national debt up to 836 trillion yen at end of June, *Japanese News Review* 24 August 2007. http://www.japannewsreview.com/business/business/20070824page_id=1735. The big sweat, *The Economist*, 13th June 2009. Stuck in neutral, *The Economist*, 15th August 2009.

of demand. Immediately after the War, the GNP dropped sharply to half that of the pre-war peak because imports from overseas had been cut off, which means that raw materials needed for productive activities were not available. The demand side arguments seem to hold true not only for Japan but for other industrialized countries too. The solution is to expand fiscal expenditures. However, after a series of expansionary fiscal actions, solid recovery simply refuses to come. Why have all the stimuli failed to pull the economy out of the deep valley of recession? This calls into question the effectiveness of such policies and therefore also the idea of a lack of demand as the culprit.

As the recession of the 1990s dragged on, the supply-side arguments had gained wide acceptance. The arguments attribute the long stagnation to the ageing population, rigid regulation, out-dated business models and old production machineries. Between them, they have resulted in substantial reduction of the growth potential of Japan. This is the position taken by, for example, the *Economic Survey of Japan* published by the Economic Planning Agency in 1998. The white paper makes the following policy recommendation: "To appeal for positive actions by all economic entities and revive the potential growth rate, Japan must urgently implement reforms to effect a transition to a market-mechanism and free-competition based economic and enterprise system with equality of opportunity, self-responsibility, information disclosure, and fixed rules as the main principles." In terms of practical measure, it means liberalization, skill upgrading, more women in work force, and new machineries. Under Prime Minister Junichiro Koizumi, it went further by introducing privatization, i.e. the kind of policies used by Reagan and Thatcher two decades earlier.

Somehow these two approaches, even when combined, have not yielded the remarkable performance of the golden decades. Why?

The Liquidity Trap

According to received wisdom, monetary authority can stimulate the economy by increasing the liquidity available in the financial system by lowering interest rates. The aim is to increase borrowing and lending, consumption, and investment. This policy has proved to work in many cases of economic downturn. However, there are situations when this policy fails to work even when the interest rate has been progressively lowered nearly to or equal to zero. Such a situation is known as a liquidity trap. It can lead to price deflation which encourages people to postpone spending because they expect prices to drop further. This can only make a recession even more severe. Until the "lost decade", no country with monetary and fiscal stimuli has experienced liquidity trap and it was seen as just a theoretical possibility after the Deep Depression. Japan has shown to the world that liquidity trap can happen with such double barreled stimuli, and it is now joined by the USA.

In practice, why does this happen? Traditionally, the monetary authority increases the overall quantity of money available to the economy by injecting into the real economy via banks. Liquidity trap occurs when banks are unwilling to lend, so the newly created liquidity is trapped behind unwilling lenders. It can also occur when businesses and consumers are not willing to borrow because they have to work away their debts accumulated during the boom years. Any further increase in the money supply along this path is not possible, as the nominal interest rate cannot drop below zero.

Various Explanations of Japanese Woes

Various reasons have been offered to explain the lost decade: ageing population, over-sized bubble, inadequate domestic demand, outmoded business models, too much regulation, rising labour cost and competition from newly industrialized countries.

Ageing Population

A factor that appears repeatedly in discussion on Japan's future is its ageing population. Japan's population started to decline in 2005, by 0.02% per year, as did its labour force. The birth rate has dropped to less than 1.3 per woman (the replacement rate is 2.1). Life expectancy is the highest in the world. The 8-million baby-boomer generation of 1947-9 is going to retire soon. By 2015, more than 25% of its people will be 65 years old or older. By 2025, the figure will be 30% compared to 12% in 1990. The proportion of working population, aged between 15 to 64 years old, is declining, from nearly 70% in 1990 to 65% in 2008 and is expected to decline to 60% in 2020.[16]

The ageing population has far-reaching impact on the technological future of Japan. In 2007, 18.2% of its work force was engaged in the manufacturing sector. The figure was one of the highest among the G7 countries. If there is no large influx of young migrant workers into this sector, the unrelenting pressure of demographic change will in due course melt away Japan's technological foundation.[17] This is extra worrying because manufacturing remains the most productive sector of the economy and main earner of foreign exchange.

The issue of migration is an issue that needs to be solved at the cultural level. Given the nature of Japanese politics, the solution has to reflect the broad consensus of the people, and a radical change is not unlikely in the near term.

Too Slow in Cleaning Up its Banks

Even though the financial crisis affected the banks very badly, it was not until 1998 that Japan began to remove dud assets and recapitalize its banks. Because of the important role of banks in credit-driven economy, it is of utmost importance to restore the functioning of the banking system, almost akin to removing the blood clog in a patient's arteries. In practice, it means bold and swift action to clean up bust banks, recapitalize weak ones and when necessary, nationalize them. But the case of Japan is different from countries which could adopt such line of action. It faced the additional

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[16] Bill Emmott (2008), *Rivals*, London: Penguin Books.

[17] Lam Peng Er (2009), Internationalisation and immigration: coping with the ageing population problem in Japan, *East Asian Policy*, July-Sept 2009, vol. 1, no. 3, pp. 78-87.

complication of requiring a large-scale restructuring of firms in such a clean-up, and this in turn would cause mass unemployment.[18]

The Ministry of Finance failed to tackle the problem of non-performing loans (NPLs) aggressively, and this had grave repercussions as macroeconomic policy mistakes sank the economy into prolonged recession and exacerbated the magnitude of bad bank loans. The collapse of the bubble saddled Japanese banks with enormous amount of NPLs. In the wake of the financial meltdown, the appropriate actions to take were aggressive disposal of bad loans, heightened prudential regulation, aggressive macroeconomic stimuli or accelerated financial system reform. Bad loans disposal would help to restore bank capital ratios and thereby decreased the possibility of systemic risk triggered by bank collapse. [19]

For most part of the 1990s, the size of bad loans was not much worse than those in other countries that experienced banking crisis.[20]

<u>Haphazard Policies</u>

After several years of fiscal expansion failed to revive the growth rate to a self-sustaining 3% growth rate, critical voices became loud enough to get notice. The subsequent debate became heated and resulted in an oscillating policy and a major policy blunder in 1997. After enjoying 3.6% growth in 1996, the Hashimoto government made a mistake with the April 1997 consumption tax increase from 3% to 5%, the end of special income tax cut and an increase in health charges. The matter was aggravated by the outbreak of the Asian financial crisis in Thailand three months later. The crisis hit Japanese banks too, especially those that had made loans to the affected countries.

Some strongly believed that had the massive fiscal expansion continued unabated, it could have helped to lift the economy out of recession. By rising demand, the cycle of rising bankruptcies could be reversed. However, this was not persistently tried, as only one third of the earmarked stimulus packages of 1992-97 were actually undertaken.[21]

Another criticism was that infrastructure spending was disproportionately directed to rural areas instead of urban areas where the needs were greater and multiplier effects higher.

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[18] Worse than Japan? *The Economist*, 14th February 2009.

[19] Jennifer Amyx (2000), Political impediments to far-reaching banking reforms in Japan: implications for Asia, in Gregory Noble and John Ravenhill edited, *The Asian financial crisis and the architecture of global finance*, Cambridge: Cambridge University Press.

[20] Dick Beason and Jason James (1999), The political economy of Japanese financial markets: myths versus reality, London: Macmillan.

[21] Adam Posen (1998), *Restoring Japan's economic growth,* Washington DC: Institute for International Economics.

Overvalued Japanese Yen

As export has formed a powerful engine of economic growth, it is natural to train the search light at this corner. In 1971, the yen-dollar exchange rate was ¥360/$1, and it appreciated to ¥240/$1 in 1985 and it surged to ¥129/$1 in 1993.[22] The rate was ¥94/$1 in July 2009. The "ever higher yen" has been identified as one primary cause of the prolonged economic slump.[23]

However, the point of overvalued yen is not convincing because the appreciation of the yen in the late 1980s was simply a correction of the prior under-valuation. The long term appreciation of the yen under the floating exchange rate system is more likely to be due to the higher labour productivity of Japan's export industries, mainly in consumer electronics, transportation equipment, precision machinery, general machinery and manufactured metal products.[24] In fact, one could make the point that the bubble was partly due to the monetary easing that was wrongly introduced to curb the further rise of overvalued yen.

More importantly, exports were extremely stable from the late 1980s through the 1990s, except for the temporary influence from the Asian financial crisis in 1997.[25] Whether the yen was strong or weak, Japan has enjoyed a current account surplus for almost all of the past decades.[26] The main reason for the rising yen is the differential between Japanese and US productivity growth rates in the tradable sector. The US-Japan inflation rate differential plays no significant role.

Had an overvaluation of yen been the problem, then a fundamental solution to this problem is a continuous coordination between the Japanese and American monetary authorities toward achieving exchange rate stability.[27] It is believed that such an adjustable peg would provide the essential mechanism for Japan to break out of its economic woes.

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22 Hiroshi Yoshikawa (2001), *Japan's lost decade*, Tokyo: The International House of Japan, pp. 98-9.

23 Ronald McKinnon and Kenichi Ohno (1997), *Dollar and yen: resolving economic conflict between the United States and Japan* Cambridge, Mass.: MIT Press, 1997.

24 Hiroshi Yoshikawa (2001), *Japan's lost decade*, Tokyo: The International House of Japan, p. 101.

25 *Ibid.*

26 Stuck in neutral, *The Economist*, 15th August 2009.

27 Paul A. Volcker and Toyoo Gyohten (1992), *Changing fortunes: the world's money and the threat to American leadership* New York: Times Books. Ronald McKinnon and Kenichi Ohno (1997), *Dollar and yen: resolving economic conflict between the United States and Japan* Cambridge, Mass.: MIT Press, 1997.

Weak Domestic Demand

At the end of the high-growth period in the 1970s, "the Japanese economy failed to develop steady domestic demand. That is, domestic demand linked with improvements in the people's standard of living failed to rise, and this resulted in the excesses of the decade-long bubble. Healthy demand growth is dependent upon the right infrastructure, and this provides the answer to the pressing and practical question of what we should do now."[28] Weak domestic demand forms a theme that appears very often in business press and scholarly discussion.[29] It is seen as the main factor that can resuscitate economic growth in Japan.

Against this argument, we can perhaps look at some figures collected by Hiroshi Yoshikawa of Tokyo University. Though he believes that the recession of the 1990s was caused by insufficient demand, he gives some figures that suggest another interpretation.[30] Between 1988 and 1993, the growth rate declined from 6.2% to 0.3%, a drop of 5.9%. During this period, the contribution of private investment to growth fell from 2.3% to minus 1.9%, a drop of 4.2%. Thus, fall in private investment accounted for some 70% of the overall decline. Similar relation is seen in the period from 1993 to 1996 when the growth rate rose from 0.3% to 5.1%, an increase of 5.4%. The contribution of private investment rose from minus 1.9% to 1.8%, an increase of 3.7%. During the second period, investment expansion accounted for nearly 80% of the increase of the growth rate. "Therefore, throughout the 1990s, capital investment was unquestionably the star in Japan's economic drama, accounting for the ups and downs in the nation's GDP growth rate."[31]

Another reason behind the low consumption can be found in the prolonged low interest rates. Interest incomes for individual savers have dropped by a trillion yen annually since 1995, and this formed a 2% drop in GDP and lower spending.[32]

The question of increasing domestic demand needs careful examination. Even in recession, Japan remains one of the richest countries in the world. The people enjoy high standard of living, and this is very convincingly manifested in their high life expectancy. Many in high growth countries who have to toil round the clock would be too pleased to trade places with the Japanese. Some termed it "Golden" recession since unemployment rate was quite low.

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28 Hiroshi Yoshikawa (2001), *Japan's lost decade*, Tokyo: The International House of Japan, p. 5.

29 Paul Krugman (1998) Japan's trap http://web.mit.edu/krugman/www/japtrap.html. Hiroshi Yoshikawa (2001) *Japan's lost decade*, Tokyo: The International House of Japan. Stuck in neutral, *The Economist*, 15th August 2009.

30 Hiroshi Yoshikawa (2001), *Japan's lost decade*, Tokyo: The International House of Japan, pp. 14-5.

31 *Ibid*, p. 15.

32 Mototada Kikkawa (1998) *Manee haisen* (money defeat) Tokyo: Bunshun Shinsho, quoted in Jennifer Amyx (2000). Rameshwar Tandon (2005), *The Japanese economy and the way forward*, New York: Palgrave Macmillan.

The rich are certainly able to spend more. But with general distrust of the long-run solvency of the state pension system, even they prefer to keep the money for future expenses. If people are not willing to do so, it is ethically wrong to force them to do so. Moreover over-consumption by them can only increase the pressure on the environment. The middle class, even if they wish to spend, cannot do so because they have to save up for their old age. This is economic rationality that should be encouraged rather than discouraged. A better way is to increase the spending power of the lower social strata by increasing their wages. An OECD report says that the workers' share of GDP fell from a peak of 73% in 1999 to 65% in 2007.[33] Another is to subsidize childcare of the lower income groups, which has the additional benefit of promoting population growth. It shows here the close linkage between social policies and economic policies.

As a way to increase domestic demand, the new government of Yukio Hatoyama has pledged to prioritize the renovation of existing housing, as well as to subsidize solar panels, "green" vehicles and energy saving appliances. This is a welcome departure from the Liberal Democratic Party's (LDP) habit of building roads and bridges that lead to nowhere in its pork barrel spending.

<u>Over-regulation</u>

The manufacturing sector has demonstrated its ability to compete in the global market on the basis of its high productivity. It is the non manufacturers that fared poorly. The poorest performers among this group are also the most heavily regulated. They are in agriculture, construction, education, healthcare, transportation, and communications.[34] Suffice it here to look at two examples. The first example is the construction industry where the procurement setup sustains highly inefficient and high-cost construction. An editorial comment in the Japanese newspaper *Nihon Keizai Shimbun* of 8 March 1999 reveals a lot:[35]

> Japan's public works budget is on the order of ¥34 trillion per year. This is equivalent to the sum total of all the public works ordered by the other leading industrialized nations combined. This makes Japan a construction giant of monstrous proportions. What is even more outrageous is that most of the works orders placed by local government bodies, which account for 70% of all public works, are knowingly given to local firms that have no construction capabilities whatever. These orders are then passed up to the leading general contractors, just as they are. The local firms do nothing productive, but they pocketed a tidy profit. Even under the current recession, there are still a vast number of such highly profitable "paper" contractors, jostling about under the surface.

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33 Stuck in neutral, *The Economist*, 15th August 2009.

34 Magnus Blomström, Byron Gangnes and Sumner la Croix edited (2001) *Japan's new economy*, Oxford: Oxford University Press. Hiroshi Yoshikawa (2001), *Japan's lost decade*, Tokyo: The International House of Japan. Stuck in neutral, *The Economist*, 15th August 2009.

35 Quoted in Yoshikawa (2001) pp. 120-1.

It must be added here that the construction industry is an important source of support for the long ruling LDP.

Another example in the regulated sector is agriculture, another vote bank of the LDP. As a percentage of the GDP, this sector has been shrinking ever since the country embarked on a program of industrialization. In 1950, it accounted for 26% of the GDP and employed 46% of the workforce. By 1970, it produced 6.1% of the GDP and accounted for 18% of all employment. However, full-time farmers account for only a small proportion of the farming community and 1% of the workforce. The vast majority of farmers are actually salaried employees who happen to own land classified as agricultural land. By virtue of the geography, Japan's agriculture is not competitive. But the situation is aggravated by regulation. It is conservatively estimated that the profits gained when agricultural land is sold and converted to other uses are nearly 30 times the land's existing value. The prospects of reaping huge gains present problems for the true farmers, who are agricultural experts. They cannot pursue economy of scale because they cannot afford to buy extra land to enlarge their plots. Most other farmers have no interest in long-term investments to improve soil conditions.[36] The result is that Japan ends up with an inefficient agricultural sector. Japanese rice cost ten times more than rice from Thailand. Japan's agriculture is seen as an impediment to genuine free trade agreement which could have further boosted its GDP.[37]

The construction industry and agricultural sector provide clear examples of how electoral politics get in the way of economic rationality. The point here is not so much the existence of regulation as the wrong regulation. The issue is getting the regulation right, and designing and enforcing regulation that promotes economic growth and well-being of the people rather than pork barrel politics.

Outdated business models

The Japanese corporate networking or keiretsu provides an organization form for cross-shareholding within groups and ties between banks and the client firms.[38] It consists of a main bank, industrial enterprises and other financial firms. It was characterized by joint ventures among group firms, extensive intra-group procurement, and loosely integrated group decision making. They adopt the following as more or less standard practices: life-long employment, bonus payment, wages and promotion based on seniority, and enterprise unions.

[36] Hiroshi Yoshikawa (2001), *Japan's lost decade*, Tokyo: The International House of Japan.

[37] Lam Peng Er, private communications.

[38] Yishay Yafeh (2003), An international perspective of corporate groups and their prospects, in Magnus Blomström *et al* (edited).

Keiretsu, once lionized as a source of Japanese economic prowess, is now often cited as potential impediments to structural reform, especially with respect to introduction of market-based reform in corporate finance and governance. When viewed in positive light, keiretsu provides efficient solution to various market imperfections. It provides an intermediate or hybrid solution to the market and vertical integration dichotomy. It reduces problems associated with transaction costs through long-term relations without full vertical integration. This applies to product development, supply chain system management, insurance and finance. The networking provides an organization mechanism for group members to share risk during financial distress. Core bank in a keiretsu plays a corporate governance role which is slowly being eroded as a result of more market mechanism. Another element is the industrial policy under the direction of the Ministry of International Trade and Industry (MITI). It uses a range of methods – subsidized credits, assistance for collaborative research, preferential access to foreign exchange, tax incentives – to advance the industrial policy by nurturing national champions to compete in the international market. Administrative guidance consists of a set of regulations implemented by the Ministry of Finance and MITI bureaucrats. But this industrial policy has been undergoing gradual and substantial change over the years.[39]

Shift to Low Productivity Sector

The biggest transition in the industrial structure during the high growth period was the shift from agriculture to manufacturing. In the 1955-1960 period, the labour productivity in manufacturing was about 1.6 times that in agriculture. In leading manufacturing firms, the gap was in the order of 6 times. The end of the high growth period in the 1970s witnessed a change in the pattern. From 1970 to 1995 the GDP share of the manufacturing sector declined from 44.5% to 33.8% while that of the service sector increased from 49.4% to 64.4%. However, the labour productivity of the service sector is much lower than that of the manufacturing sector.

"This means that on the supply side, the Japanese economy has witnessed a long-term shift of production resources from high productivity to low productivity industries. In fact, this has been one of the main problems facing Japanese economy ever since the 1970s."[40] This mismatch between demand growth and productivity decline holds tremendous long-term consequences for the economy.

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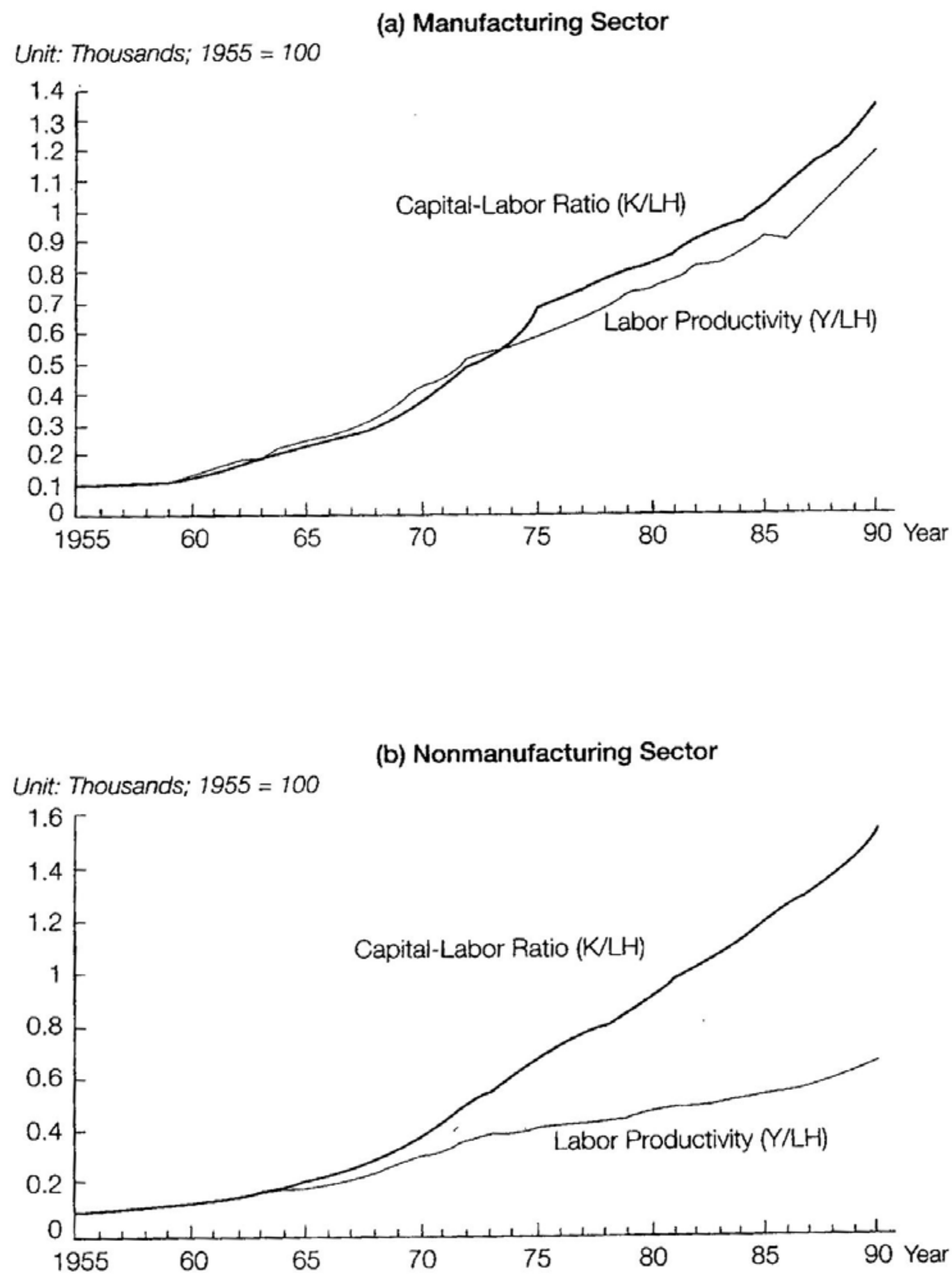
[39] Magnus Blomström (2001).

[40] Hiroshi Yoshikawa (2001), *Japan's lost decade*, Tokyo: The International House of Japan, p. 112.



Capital-Labor Ratio and Labor Productivity (1955-1990)

Note: K = capital stock; Y = real GDP; L = number of employed workers; H = working hours.
Source Data: Economic Planning Agency, *National Accounts Annual* and *Private-Sector Enterprise Capital Stock Statistics*; Ministry of Labor, *Labor Statistics Monthly*.

Source: Japan Development Bank, *Surveys* (No. 171; May 1993); pp. 17–18.

from p. 113 of Hiroshi Yoshikawa (2001), Japan’s Lost Decade, Tokyo: The Industrial House of Japan.

Changed Business Environment

It may be useful to recollect how Japan did so well before the onset of the crisis in 1990. The development of the Japanese economy is a combination of both the qualities of the Japanese people, and external environment and luck. [41] The high growth period coincided with a world-wide boom and expansion in world trade. It was able to invest in new technologies from abroad, import cheap raw materials, and export quality products. Japan was able to put in place supportive institutions at home; it had few competitors while operating in an expanding global market. During the Cold War period, the US opened its huge market to its Japanese ally even though the latter was relatively protectionist.

But the environment has changed. The newly industrialized countries have already learned so well from the Japanese that they are churning out many if not all the goods that had once brought accolade to Japan. Though a good proportion of these goods are produced by Japanese companies relocated to China and Southeast Asia to take advantage of the low production cost, Japanese workers have lost their jobs and Japanese suppliers have lost their business. South Korea's Samsung and LG in television, and China's Haier in home appliances, Huawei and ZTE in data-communications threaten to do to Japan what Japan did to the USA and West Europe. They produce high quality goods at lower prices. Moreover, in the 1990s when China, India and the ex-Soviet bloc joined the capitalist world, the global labour pool grew from 1.5 billion to 3 billion.[42]

Back to Basics

With the benefit of hindsight, one can see some of the roots of the current economic woes in the 1970s. In the aftermath of the oil price hike in 1973, Japan suffered a recession in 1974 and an inflation of more than 30% that year. Investment rates fell and growth slowed to the 5% range in the late 1970s. "This slowdown in economic growth was partly due to the lingering effects of the OPEC oil price shock, but more fundamentally it also reflected the rapidly diminishing returns to new investment as Japan converged with other developed market economies."[43] In other words, Japan began to experience the slower growth of a mature industrial economy. Meanwhile, the late comers in the form of newly industrial countries (NICs) are fast catching up.

Traditionally, it was believed that land, labour and capital are the key factors. If we are to broaden the factor of land to include natural resources and strategic geographical position, we still find this traditional concept inadequate. Suffice it to mention the often quoted cases of how some oil rich countries have got stuck in their

[41] Ryuichiro Tachi (1993), *The contemporary Japanese economy – an overview* Tokyo: University of Tokyo Press.

[42] The left's resignation note, The *Economist*, 13th Dec 2008.

[43] Magnus Blomström, Jennifer Corbett, Fumio Hayashi and Anil Kashyap (edited) (2003), *Structural impediments to growth in Japan*, Chicago: Chicago University Press, p. 4.

dependency on oil export as the main source of national income and fail to embark on the more arduous journey of industrialization.

The case of Japan provides a powerful argument for an alternative view, namely, the economic well-being of a country lies in its productivity, based on innovation broadly defined. One fruitful way of looking at innovation is offered by the economist Joseph Schumpeter.[44] He describes innovation as follows: (1) the introduction of new goods, (2) the introduction of new production methods, which may be based on scientific discovery, (3) the development of new markets, (4) the development of new sources of new materials, and (5) the creation of new organizational forms. He calls for new combinations of factors of production to replace old ways, as encapsulated in the famous phrase "creative destruction". In his framework, supply does not automatically create demand. One must be able to produce goods that are in high demand or have the potential to generate demand. Two examples of such goods today are cell phones and (especially for the young people) iPods but unfortunately they are not invented by Japanese firms. Another example is new drugs to enable senior citizens to stay healthy and continue to work. Japan is well positioned to embark on such innovation as it has a strong technological base and growing ageing population. Such medical and technological advances call for new scientific breakthroughs. "As they reached the technology frontier, Japanese firms have had to reorientate their R & D efforts from the application and refinement of existing, relatively well-developed technology to the creation of more fundamental breakthroughs."[45] Even today, in spite of the long slump, Japan still has many world class firms, most of them technological. For example, Toyota in car manufacturing, Nintendo in computer games, Shimano in bicycle parts, Nikon in cameras and the precision lenses for making semiconductors.[46] But to break out of the economic doldrums, Japan needs many more of such companies. The world will be delighted if Japan can channel some of its restless innovative technological power to produce an array of green technologies.

Innovation can also take the form of enhancing the productivity of the service, agricultural and other regulated sectors. Here a word of caution is in order. Rather than taking on the approach of business reengineering or process redesign once much in vogue in America, Japan will probably embark on the exercise on its own terms. Perhaps it is useful to be reminded that America is more an exception rather than a normal case in the world. No society and no country can escape the burden of the past and the weight of tradition. Here Japan can take heart that the nation has accumulated impressive historical experience in introducing reforms as illustrated in its Meiji Restoration and its economic rejuvenation after the Second World War.

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[44] Joseph Schumpeter (1934), *The theory of economic development*, Boston: Harvard University Press.

[45] Lee Branstetter and Yoshiaki Nakamura (2001), Is Japan's innovative capacity in decline?, in Magnus Blomström *et al* edited, *Structural impediments to growth in Japan*, Chicago: Chicago University Press, p. 183.

[46] Nothing to lose but their (restaurant) chain, *The Economist*, 7th Feb 2009.

Moreover, Japan provides a very fine example of how it has been able to place the welfare of the people and social harmony above attractive GDP figures. [47]

Schumpeter thus offers another way of looking at how Japan can seek a way out of the economic malaise. The dichotomy of supply and demand is not the right way to pose the question. In fact, it is a false dichotomy. Consider the case that manufacturers are so good in producing washing machines that there is an oversupply of them. It does not make sense for one household to have more than one washing machine. Fiscal and monetary expansion to stimulate demand does not solve the problem. Neither does a drop in wages as a means of cutting production cost offer a way out.

On the business scene, a positive response to the "lost decade" calls for entrepreneurs, i.e. business people with foresights and risk taking spirit (note: not speculation or gambling). For an entrepreneur to be able to promote new combinations of factors of production, somebody must put the means of production in his hands. It is here that banks and credit can play an important role. The financial crisis which originated in Wall Street shows that Wall Street bankers have failed miserably in their duty as financial intermediaries.

Wider Societal Problems and Cultural-Intellectual Challenges

The main national concern of Japan after the Second World War has been to build a strong economy, perhaps in the hope that everything else will do well or will fall in place. The rising economy sustains a buoyant national spirit. When the economy gets stuck in a malaise, its mood turns blue. "The prolonged recession has given rise to a stifling feeling of being locked inside a box with no exit in sight, and has cast a dark shadow on the national psyche. The sudden increase in suicides as reported by Japanese newspapers is simply shocking."[48] It is not just shocking, it is also sad.

The recession is egregiously long and tenacious, which prompts deeper and more reflective enquiries. It is a crisis of governance in both government and business; a revival will require a fundamental overhaul of several institutions, though even reformers cannot agree among themselves as to what this means.[49] It is also a crisis which evokes the image of cul-de-sac. Policymakers in Japan recognize that the economic and financial arrangement that served Japan so well during most of the postwar period is no longer compatible with the new economic, technological and political environment.[50]

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[47] Peter Drucker (1998), In defense of Japanese bureaucracy, *Foreign Affairs* Sept-Oct vol. 77, no. 5, pp. 68-80.

[48] Hiroshi Yoshikawa (2001) *Japan's lost decade*, Tokyo: The International House of Japan, p. 2.

[49] Rameshwar Tandon (2005), *The Japanese economy and the way forward,* New York: Palgrave Macmillan.

[50] Magnus Blomström and Sumner La Croix (2006), *Institutional change in Japan,* London: Routledge.

Compared to other mature economies, Japan's unemployment rate should be considered normal. Crime rate is low. The situation of drug abuse can easily be the envy of America. In terms of societal indicators, Japan should be happy with itself. Here, one is reminded by the cliché that happiness is a state of the mind. It really is, if one has a roof over the head and food on the table.

Beyond increasing economic growth, perhaps what Japan needs more is revival and rejuvenation in the field of culture, ideas and intellectual exploration. Would not it be exciting to see many more of Japan's best and brightest being inspired to become poets, novelists, artists, essayists, men/women of letters and philosophers who can express the spirit of the time in its loftiest forms and most forward-looking terms, to contribute something enduring to world civilization?[51]

Such cultural and ideational contributions have a pragmatic dimension too. They can provide a cultural and intellectual framework for social and economic reform. The process of institutional change and reform involves all facets of society. Among other things, it depends on the ability of politicians, intellectuals, and managers to fashion an ideological consensus around distinct types of institutional change.[52] New institutions and institutional reforms need the cultural bedrock and progressive ideas associated with ground breaking philosophies. For example the narrow nationalism of Japanese is out of synch with the cosmopolitanism of the global condition. Such social and cultural attitude discourages immigration that is badly needed to cope with the problem of ageing population, a point we briefly touched on earlier.

The Relevance of Globalization

Globalization in its earlier form several decades ago has enabled Japan to pull off an economic miracle. It has continued to help Japan, which needs the rest of the world as sources of production input as well as market. However, of late, it has also posed a challenge to Japan in the form of the NICs. For example, Japan's laptop industry has been gradually losing ground to its Taiwanese counterpart. The way Japan runs its mobile telephony suggests that Japan is adopting a protectionist route. Its mobile technology differs from those used by most other countries.[53] By doing so, it loses a golden opportunity to carve for itself a strategic position in the global mobile phone market. None of the following recent and current big brands are Japanese: Ericsson, Motorola, Samsung, Nokia, and iPhone.

Given its creative and high-tech flair, Japan would do well to face up to the challenges of globalization, both for its own good and the good of others. Japan's growth will need to be driven by improving its productivity, investment abroad and

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[51] The case for such a cultural and intellectual revival for Asia and China was discussed below: Heng Siam-Heng (2007), Asian Renaissance and Enlightenment – problems and prospects, *Akademika*, vol. 71, pp. 117-123. Siam-Heng Heng (2008), China's cultural and intellectual rejuvenation, *Asia Europe Journal*, vol. 6, pp. 401-412.

[52] Magnus Blomström, Byron Gangnes and Sumner la Croix edited (2001), *Japan's new economy*, Oxford: Oxford University Press.

[53] Japanese cellular phones FAQ http://euc.jp/misc/cellphones.en.html#import

reallocating its manufacturing activities overseas. Outward investment has helped Japanese firms maintain and even expand global market shares and contributed to the restructuring of the Japanese economy away from older industries. Given its huge current account surplus and programs of industrial development in many countries, Japanese outward FDI has scope for significant increase. The move is bound to affect low level manufacturing at home. This will act as a catalyst in restructuring and upgrading of the Japanese economy towards more advanced activities with higher value added. Inward FDI is likely to exert a strong impact on the restructuring of the Japanese economy. Deregulation has opened up much of the industrial and service sectors to foreign participation, and in the process it has introduced new technologies and business practices. This has eroded the cross-shareholding relationship within the keiretsu groups, and has facilitated merger and acquisition activities between Japanese and foreign firms. The level of competition and inflow of foreign technology will increase, with higher productivity growth as a major result.[54]

The globalization perspective does not see stimulating domestic consumption as the magical solution to the economic problem. The argument for such "magical solution" assumes implicitly a linear model of social and economic development. Under such a model, something must be done to reverse the current trend of weak domestic consumption which results in anemic growth and growing trade surpluses. It must be noted that such linear model has proved to be wrong time and again in social change. Let us put aside such linear model and consider another approach to see how Japan can help itself and others by working out a better approach. Let us consider the world economy as an interlocking and mutually dependent system. Japan with its surplus capital and advanced technologies can play a positive role in exporting capital and technologies.

A special aspect of this is Japan's economic relation with China. After Deng Xiaopeng's famous southern tour of the free trade zones, China embraced free market economy in greater scope and depth. Subsequent economic development has bound the fate of the economy of the two countries more tightly together. China's advance has hollowed out Japan's labour-intensive industries while it has provided Japan with a substantial market for high quality consumer products and advanced technologies.

As long as Japan does not go around what others can do well, it will contribute to the growth and technological advancement of the host countries. There is a win-win situation for Japan to aim for. In the domestic scene, it focuses on making new technological breakthroughs, and improving its productivity and innovation in the service sector. Seen in this light, the trade imbalance is not a source of worry. Socially Japan should be given the leeway to protect sectors that employ those who cannot catch up with the demands of such economic transformation. The good thing here is that unlike America, Japan has the deep tradition of placing society above economy.[55] Other countries would do well to refrain from exerting pressure on Japan and let it make its own decision. Social unrest in Japan is not good for its neighbours and allies.

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[54] Magnus Blomström *et al* edited (2001), *Structural impediments to growth in Japan*, Chicago: Chicago University Press, p. 20.

[55] Peter Drucker (1998), In defense of Japanese bureaucracy, *Foreign Affairs* Sept-Oct vol. 77, no. 5, pp. 68-80.

Learning from Japan's Travails

We began this paper by suggesting that the Japanese experiences could have something to offer in (1) understanding the problems besetting the USA and Britain, (2) understanding the nature of recession in a mature economy, and (3) providing useful historical experiences for other Asian countries which are fast catching up in economic growth.

First, the Japanese experience holds a message for the USA and other countries that have suffered real estate bubble. In very bad cases, it leads to a long period of recession that fails to respond to aggressive monetary and fiscal stimuli. The price declines following bubbles can last for many years and excess capacity can take years to work off. Meanwhile owners of empty properties have to cough up money to maintain them. The fear that the USA may follow the footstep of Japan is real. However, a closer look suggests that things may not turn out so bad for Uncle Sam because of two reasons. The first reason lies in the fact that America is spreading the burden of its housing bubble across the whole globe. Foreigners hold a big chunk of American mortgage-based securities. Sovereign wealth funds have injected funds into American banks. Unlike the sharp appreciation of Japanese yen after the bubble burst, the American dollar has remained weak, which helps its export.[56] The other reason is demography. When the bubble burst in Japan, the country was already ten years into population decline, and the trend continues to this day. By contrast, America has continued to experience gradual population growth, which helps to work away the excess housing units. Having said this, the picture is still gloomy. Experiences of other countries of different backgrounds have shown that serious asset-price bubbles often lead to economic downturns lasting several years.[57]

Japan has entered the recession as a creditor nation rich in domestic savings. Its savings are estimated to be equivalent to $15 trillion. This is not the position enjoyed by the USA. In America, private sector debt shot up from $22 trillion in 2000 (equivalent to 222% of GDP) to $41 trillion in 2007 (equivalent to 294% of GDP). The corresponding figure in Japan was 35%. *The Economist* (14th February 2009) reports an estimate by Goldman Sachs, suggesting that American banks held some $5.7 trillion worth of troubled loans such as subprime mortgages and commercial property. This is equivalent to almost 40% of GDP. [58]

The message is short but not pleasant. The USA and Britain may face a long and slow recovery and anaemic growth for the coming years.

The second message suggests we need to look at the limitations of fiscal and monetary stimuli, and productivity as the fountain of economic well-being. In a mature economy with a high standard of living, such stimuli may fail to work their magic in a deep and painful recession. The social situation in the rich countries today is very much different from that in the 30s and 40s. Moreover, the world today does

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56 Lessons from a "lost decade", *The Economist*, 23rd August 2008.

57 Lessons from a "lost decade", *The Economist*, 23rd August 2008.

58 Worse than Japan? *The Economist*, 14th February 2009.

not present the USA with a huge export market, unlike World War II and the devastated landscape in its aftermath.

The key to economic well-being lies thus in productivity, innovation and technological breakthroughs. The rich Western countries still boast of most of the top transnational companies, world class research universities and laboratories. Such resources should be tapped to become the core engines of economic growth. Instead of churning consumer products whose supply has exceeded demand, it is in their enlightened interests to come up with green technological products and new ways of running businesses that release the creative potential of their employees. The whole world will welcome more of the types of Google, Apple and Nokia rather than General Motors and Merrill Lynch. There is much for the world to learn from American dynamism and entrepreneurial spirit. After all, its IT industry has been the most dynamic sector of the US economy in the 1990s.

At the same time, there is much scope for increasing productivity. One simple way is to identify causes that increase costs unnecessarily, either directly in the cost structure of the company or via costs borne by society. Two examples of the first type are litigation and the patent system. The following report reveals how much can be saved in these two areas to boost the US economy.

> Litigation cost the country $252 billion in 2007, according to Towers Perrin, a consultancy. At nearly 2% of GDP, that is about twice the burden that lawsuits impose on other rich countries. Yet the Pacific Research Institute (PRI), a conservative think-tank, thinks it a gross underestimate. By including indirect costs, such as products never launched for fear of litigation, PRI arrives at a total of $865 billion a year. Of this, it reckons two-thirds is wasted; that is, it neither compensates the injured nor deters the reckless. ….
>
> “Patent trolls” pose another problem. These are firms that buy up patents, not to turn them into products but solely to sue other firms that may have infringed them. Since the United States Patent Office grants patents freely and courts enforce them zealously, every inventive company lives in fear of trolls. If one can convince a court that a billion-dollar product incorporating hundreds of patents infringes only one of his, he can get an injunction to stop it being sold. The victim typically settles. Michael Heller, author of “The Gridlock Economy”, argues that such vaguely defined and aggressively asserted property rights stifle innovation and cost lives.[59]

There are other areas which drain away American productivity. Suffice it to mention here healthcare, crime, high prison population, drug abuse, poor education, and traffic congestion. Though they are often featured in news reports and commentaries, they have a stealth-like quality. Their economic impact is often not too obvious to ordinary people. They are surely not problems that can be tackled easily or within the four walls of a firm. They are of a societal character and would require the

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[59] Robert Guest (2009), Red tape and scissors, *The Economist*, 30th May 2009.

political will, intellectual vigour and cultural resources of the American society to solve them.

The third message is more relevant to the rest of the members of the flying geese. Financial liberalization is a process that can bring along some unexpected and nasty consequences. Certainly it can be beneficial to some parties, but the overall result for the economy may be a long recession. Of all aspects of globalization, financial liberalization has a very vicious and poisonous tail. Malaysia did go along with financial liberalization, only to pull back during the Asian financial crisis. China and India have been very cautious in opening up their financial market and do not lift their control of capital flows. Events have vindicated the wisdom of their caution.

The Japanese experience holds another message for us. GDP growth built on rising property prices does not produce real economic growth. There is a striking difference between the manufacturing sector and nonmanufacturing sector in Japan. The latter invested heavily in real estate during the bubble period and created the bad debts that plagued the economy. Of course, banks which financed such speculation are also part of this sector. If they are lucky, they may reap huge profits, but that in itself will not and cannot enhance the competitive edge of the companies. In bad cases, it leads to the "lost decade" of Japan and the US subprime debacle. In milder cases, real estate speculation contributes to the cost of doing business by virtue of higher rentals, and works against a country's global competitiveness. Moreover, capital channeled to real estate speculation means less money directed to productive investment. GDP growth built on rising property prices due to speculation does not produce real economic growth. It holds clear message for not just Japan, but other countries deeply embedded in the global economy.

The next point is that in spite of the long recession, Japan has not experienced much social dislocation. Unlike most other industrializing countries, Japan has been able to undergo drastic economic transformations without much social upheavals. This can be attributed, at least in large measure, to the primacy Japan has given to society above economy.[60]

To nurture creative and innovative minds, a special role has to be assigned to the education system. The educational tradition in Japan emphasizes doing well in examinations, with good schools becoming experts in exam-drilling type of instruction, and with school and university students scoring top grades. The heavy load of books the students drag to school speaks volumes. Students are under immense pressure to perform in exam, and a few who cannot take the pressure prefer to take their own lives. For obvious reasons, students hate schools. The challenge for Japan, and also for other members of the flying geese, is to make school a pleasant and enjoyable environment for discovery-based learning rather than rote learning. Students should be encouraged to reason for themselves. While they need to respect authorities, they must be encouraged to question authorities. All great truths begin as blasphemies, so says George Bernard Shaw.

[60] Peter Drucker (1998), In defense of Japanese bureaucracy, *Foreign Affairs* Sept-Oct vol. 77, no. 5, pp. 68-80.

Conclusion

The "lost decade" is a key element in understanding the general election on 30 August 2009 in which the Democratic Party of Japan (DPJ) won a landslide victory. In throwing out the long-ruling Liberal Democratic Party (LDP), the people have shown their disapproval of the Party's continuing failure to respond to the fallout of the bubble. It is not so much of a vote on ideology since both parties are basically conservative.

During the election campaign, the DPJ appealed to the popular sentiment that under LDP the people were losing a largely egalitarian society and a sense of economic security. Such certainties had been swept away by the reforms inspired by Anglo-American free market liberalism of former Prime Minister Junichiro Koizumi. In the campaign, the DPJ was given a hand by the global recession originating from Wall Street excesses. People were happy to lend their ears to DPJ leader Yukio Hatoyama's criticism of "unrestrained market fundamentalism and financial capitalism."

By early September, the DPJ has pledged the following:

1. To cut back big government construction projects. Some of the money saved will go to subsidies for green technologies, such as a proposal to pay half the cost of installing solar-power systems in homes. The new government wants to reduce Japan's carbon emissions by 25% below 1990 levels by 2020.

2. To boost consumer spending by reducing taxes and fees. It plans to halve the petrol tax of ¥54 a litre and gradually eliminate highway tolls, reduce the tax rate for small firms from 18% to 11%, increase the minimum wage to ¥1,000 per hour eventually from ¥629 today and roll back Koizumi's reforms that allow manufacturing firms to hire temporary employees.

3. To improve health care, expand financial assistance for the unemployed and provide a minimum monthly pension of ¥70,000, give parents ¥26,000 a month for every child aged 15 and under, and remove the tuition fees for public high schools of around ¥120,000 a year.

Moreover, these measures are aimed at giving people a sense of financial security which hopefully has the side effect of encouraging them to spend more and boost domestic demand. If all goes well, the pro-family measures would nudge young couples to be "fruitful and multiply". Like many other socio-economic plans or programs, there are some inherent inconsistencies, such as between its environmental policy and lowering petrol taxes. There is a huge question mark of how it is going to find the money to pay for the plans.

As to the ambitious carbon reduction goal, Hatoyama might well deserve the title of a visionary and not a dreamer. According to Martin Schulz of the Fujitsu Research Institute in Tokyo, the 25% target is not outrageously high, only just beyond what the European Union is pledging. The move is hailed by environmentalists, all the more so when Japan is already the most CO_2 efficient around. "We welcome the courage of Yukio Hatoyama and believe he has the strength to set Japan on track for a low carbon future which will benefit people and nature, both in Japan and worldwide." [61]

To achieve its goals, the DPJ need not depart radically from the way Japan is run. In other words, it does not need to dump the triangular relationship of the ruling party, the bureaucracy and business. However, to broaden the social basis and resources of its program, it should welcome the participation of NGOs, social activists and other groups of public spirited individuals. Their inputs are all the more needed if the state is to encourage women to play the dual roles of mothers and members of the workforce. In the process of solving social-economic problems, a new institutional arrangement will evolve, open to input from more sources and more responsive to changing demands of an evolving global order. To paraphrase Putterman and Rueschemeyer, given Japan's role in global economy and the deep-rooted nature of its economic problems, the project represents historically an institutional innovation of the first order, based on tremendous political, economic, and cultural resources and guided by trial and error in the pursuit of large-scale enlightened interest.[62] It must eschew certain aspects of its protectionist tendencies and forge a forward-looking and cosmopolitan culture and undergo an intellectual rejuvenation to replace its narrow nationalism. To build a new model to take its place requires more than just political power. It needs fresh ideas and new cultures to underpin new mindsets and institutional innovations. In the process, it would contribute to the global economy and modern world civilization.

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[61] Japan's break with past on climate, BBC News, 7 September 2009 http://news.bbc.co.uk/2/hi/science/nature/8241609.stm

[62] Louis Putterman and Dietrich Rueschemeyer (eds.) (1992), *State and Market in Development: Synergy or rivalry?* London: Lynne Rienner Publishers, p. 245.