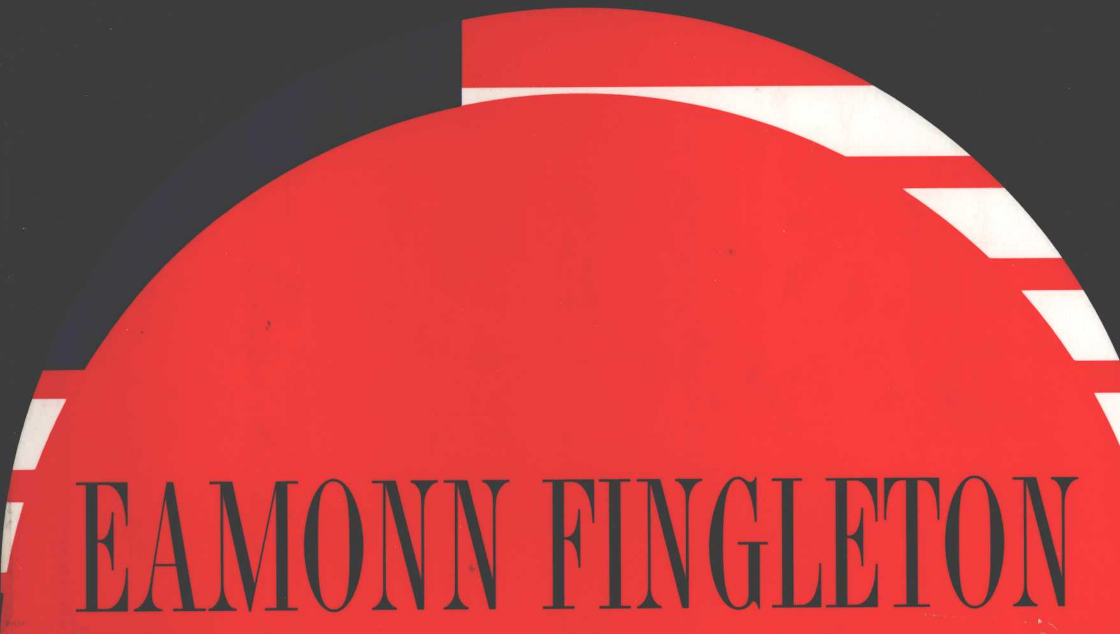
BLINDSIDE

WHY JAPAN IS STILL ON TRACK TO OVERTAKE THE U.S. BY THE YEAR 2000



EAMONN FINGLETON

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A Note on the Japanese Language

To facilitate the pronunciation of the Japanese words mentioned in this book, here are some basic rules for pronouncing the Japanese language.

a as in c*a*r
e as in t*e*n
i as in sk*i*
o as in m*o*re
u as in R*u*mania
ai as in *ai*sle
au as in b*au*h*au*s (or as ow in c*ow*)
ei as in r*ei*ndeer
ou as in th*ou*gh
ch as in *Ch*ina
g as in *g*o
s as in *s*ee
y as in *y*oung

Other letters are pronounced as in English.

It is important to remember that, whereas English is written in letters, the basic unit of written Japanese is the syllable. Generally each syllable is given approximately equal weight in pronunciation. Take, for instance, *konnichiwa,* which means hello. The pronunciation is kon-ni-chi-wa. Similarly *sayonara,* meaning good-bye, is pronounced sa-yo-na-ra. In general every syllable is sounded. The Japanese rice wine *sake,* for instance, is pronounced sa-ke.

For English speakers, one of the many peculiarities of Japanese is that it does not generally have separately designated plurals. Thus the plural of *samurai* is *samurai*. In this book I treat important terms of Japanese business life as English words and give them English plurals. Thus the plural of *keiretsu* will be rendered *keiretsus*.

Like other East Asian languages, Japanese usually places people's given names after their family names. In accordance with the practice of the Western press, however, I present these Japanese names in Western order, given name first.

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Sayonara, Capitalism

Anyone who looks at the record notices a striking pattern: the West always seems to underestimate Japan. Some systematic flaw in Western psychology leads Westerners, and particularly Americans, to exaggerate Japan's weaknesses and belittle its strengths.

Few Americans other than historians of Japanese economics realize quite how consistent this pattern is. Although anecdotes about American corporations being caught off-guard by fast-moving Japanese competitors are part of American corporate folklore, Americans have tended to blame such disasters not on flaws in American psychology but on the exceptional incompetence of a few supposed "dinosaurs" of American business. The truth is that such experiences are the rule rather than the exception in America's many-faceted relationship with Japan. America's most influential newspapers and policy think tanks have, if anything, an even more embarrassing record than American business of underestimating Japan.

This pattern goes back to Japan's emergence as an industrial power in the last century. It has become even more noticeable in the five decades since the United States defeated Japan in World War II.

General Douglas MacArthur set the tone in an interview with the *New York Times* in September 1945, just a month after Japan surrendered. Speaking in his capacity as head of America's program to democratize the defeated Japanese, he flatly declared: "Japan will never again become a world power." Less than two decades later, Japan's postwar economic miracle had already proved MacArthur wrong. By 1964, the year he died, Japan ranked as the world's third-largest manufacturing power, after the United States and the Soviet Union.

Over the years almost every diplomat, writer, and policymaker who has tried to assess Japan has erred similarly on the downside. Here are some examples:

• In 1950, MacArthur's American economic experts advised that the Japanese economy's best course in the postwar era would be to make "knickknacks" — their word — for underdeveloped countries. Japanese exporters aimed a bit higher. By 1987 the American military had become so dependent on Japanese electronic "knickknacks" that the Pentagon launched the $1 billion Sematech program to revive the beleaguered American electronics industry.

• In 1957, Columbia Pictures released *The Bridge on the River Kwai,* a World War II epic that painted Japan's military engineers as incompetent oafs. Today the joke is on Columbia Pictures, which has been owned by Tokyo-based Sony Corporation since 1989. For Sony chairman Akio Morita, this represents one of the great last laughs in history: he started his career in the early 1940s as a Japanese military engineer.

• In 1972, the American foreign policy analyst Zbigniew Brzezinski published *The Fragile Blossom: Crisis and Change in Japan*, in which he publicized various overblown "crises" that seemed at the time to be undermining Japan's social contract. Less than two years later, in facing a real crisis in the form of the Arab oil embargo, Japan reacted less like a fragile blossom than a mountain cat. In the teeth of widespread predictions in the West that Japanese industry would collapse, Japan adapted so quickly that it was able to surpass the United States in several crucial oil-related industries by 1980.

• In 1989 Bill Emmott, editor in chief of the influential London magazine the *Economist,* wrote a book arguing Japan's savings rate would soon fall and this would eliminate Japan's trade surpluses. Instead of falling, the savings rate actually rose — with the result that in the next four years the current account surplus more than doubled!

Why do top Western observers continue to misread Japan? Several factors are at work. These include:

1. *Cultural misunderstandings.* The Japanese consider it a form of politeness to engage in ritualized understatement of themselves and their institutions. Sometimes they take this modesty to ludicrous ex-

tremes. In the presence of a non-family member, for instance, a polite Japanese father may even pour ritualized scorn on his own family. He may refer to his son as "gusoku," a characteristic idiom that literally means "my stupid son." The son involved may be a brilliant overachiever — but that is the point. The intent of the father's modesty is to spare the blushes of his hearer whose children may not be as gifted.

2. *Japanese public relations strategy.* Japanese officials and business leaders have found that it is good strategy to play down Japan's economic strengths. They are practiced hands at acting out pantomimes of exaggerated anxiety that serve not only to spur Japanese workers to ever greater efforts but to foster complacency among foreign rivals.

3. *Western hubris.* The Western mind has a powerful subconscious wish to look askance at Japanese economic ideas. This wish is so strong that Westerners time and again suppress the hard evidence of their senses and even invent fictitious "facts" in an effort to preserve their condescending view of Japan.

The Japanese economic system has often tended to understate the profitability of its corporations, the productivity of many of its workers, the living standards of its consumers, and even the strength of its financial system. The Western press, eager to criticize Japanese economics, generally takes the self-deprecatory comments of Japanese economic leaders at face value.

The result is that even the most sophisticated Westerners are hopelessly in the dark about the reality of Japan in the mid-1990s. In particular, they are blind to one of the most consequential events of the twentieth century: the emergence in Japan of a revolutionary new system of economic thought that is now visibly overturning many supposedly universal theories that shape Western economic behavior.

Not only have the West's economists failed to understand this new system but, with almost no effort to study the underlying facts, they continue to condemn Japanese economics as a backward, almost irrational system that trails far behind the West in economic evolution. True, a few noted Western economists such as Lester Thurow and Michael E. Porter have come to admire certain features of Japan, notably the rigor of its educational system and the long-term mindset of its big banks. But even such observers have failed to grasp the full picture. They see Japanese economics merely as a "new paradigm" of

Western capitalism. The truth is, though many aspects of Japanese economics look like capitalism, the Japanese system is not capitalism at all but a new formulation that is as sharp and portentous a break from capitalism as capitalism was from feudalism.

In essence, the Japanese have discovered that the basic assumptions underlying the West's economic thinking have been undermined by a sea change in the way wealth is created in advanced countries. Japanese government and business leaders spotted this sea change as early as the 1930s and, on the strength of radical economic experiments carried out by the Japanese military in Japan's then colony of Manchuria, they devised a new economic system better able to create growth in modern conditions than capitalism. This system was sketched out in a historic government manifesto in 1940 and was substantially implemented by the late 1940s. Labeled in English the Economic New Structure, this system quickly proved an extraordinary advantage in Japan's effort to catch up with the West. And today it is a bigger advantage than ever. Precisely because this system is so effective, Japanese leaders have shied away from discussing it frankly with Western policymakers and economists — and even with the Japanese people. But in the mid-1990s the outlines of this new system are fully visible to those who can shed their Western hubris and evaluate it on its merits.

The Japanese collapse that never was

The West's tendency to underestimate Japan was rarely more evident than in the way Western observers misinterpreted Japan's economic performance in the early 1990s. Virtually without exception, commentators in the West maintained that Japan was going through an economic agony as terrible as the wrenching recessions in the United States and Britain. As reported by the American press, Japan entered a "slump" after the Tokyo stock market peaked at the end of December 1989 and was still supposedly floundering four years later.

Language-blocked American correspondents simply assumed that because the Tokyo stock market had collapsed, the Japanese economy must also be in terrible shape. As we will see in Chapter Ten, this was a classic case of applying inappropriate Western logic to Japan: given Japan's very differently structured financial system, stock market turbulence did not constitute a threat to the extraordinary efficiency of the advanced industries at the heart of the Japanese economic miracle.

The remarkable thing about the early 1990s in Japan was how well the economy was doing in the face of the worst global recession since the 1930s. Here are some facts that the American press's prophets of doom overlooked in the early 1990s:

• Measured by current exchange rates, Japan surpassed the United States in 1993 to become the world's largest manufacturing economy.

• Japan jumped from sixth to second in per capita income between 1989 and 1993.

• In 1992, Hitachi passed IBM, America's largest high-technology company, in sales.

• Japan's net national savings totaled $819 billion in 1993. As calculated by the Paris-based OECD, this represented 56 percent of the entire industrial world's savings. By contrast, the United States' savings came to just $75 billion, or only 5 percent of the industrial world's total.

• Japanese employers consistently invested two to three times as much per worker as American employers.

Underlying all this was a stunning performance by the yen, which soared 27 percent in the first four years of the 1990s to finish 1993 at ¥112 to the American dollar. As the yen rose, the reaction in the West was disbelief. Western commentators did what they have always done when the yen rises: they predicted that Japan's exports would soon be priced out of world markets and major Japanese exporters would be forced out of business. Nothing of the sort happened. Instead of falling, Japan's export revenues rose even in yen terms and soared in dollar terms. We will look at the reasons later. For now let us just look at the numbers: exports reached $362 billion in 1993, a rise of 32 percent since 1989. With exports booming, not a single significant employer collapsed, and as of 1994 unemployment stood at less than 3.5 percent. Certainly, if the stock market crash threw people out of work, this was not apparent in Japan's total work force, which rose by about 1 million a year even as stock prices slumped.

The bottom line on the early 1990s is this: powered by the strong yen, Japan ended 1993 with an economy 68 percent the size of America's. By contrast, four years earlier when the Tokyo stock market was riding high, Japan was just 55 percent of America's economic size. In other words, Japan remained triumphantly on track toward its reputed goal of passing the United States to become the world's largest economy by the year 2000.

Seeing things as they are

American economists and business publications use a host of devices that systematically obscure the truth about Japan's strength.

In particular, in making U.S.-Japan comparisons, they value the yen at 30 to 50 percent less than the market rate. This reflects the use of the so-called purchasing power parity method of currency translation. Advocates of this method regard the yen as grossly overvalued at recent exchange market rates. Thus, unbeknownst to the American public, they "correct" Japan's economic numbers downward by valuing the yen at the low levels of a decade ago. As a result, Japanese incomes are often stated as if they are considerably lower than American incomes, when in fact they are more than 30 percent higher.

The purchasing power parity method therefore deflects attention away from one of the most important questions of the 1990s: How can high-wage Japan outexport America in virtually every category of manufactured product — and do so with just half of America's work force?

American economists justify the purchasing power parity method on the basis that, thanks to high retail prices in Japan, Japanese consumers get less for their money than income numbers translated at market exchange rates would imply. But, as we will see, purchasing power parity calculations are highly misleading because of a host of cultural factors overlooked by Western observers. In any case, anyone who measures Japan's economic performance by the Japanese people's standard of living misses the point: Japanese leaders do not share the Western view that the economy should be primarily run to provide citizens with a good life. Rather, they see the Japanese economy mainly as an instrument of power. And the mighty yen, which has trebled against the dollar since the early 1970s, is one of the principal levers of that power.

Nowhere is the changing balance of power more apparent than in corporate rivalry. Driven by the high yen, Japanese corporations are now the sales leaders in most industrial sectors. Even in high technology, as we have seen, IBM has had to make way for Hitachi. Skeptics wonder whether this matters. Actually, it does. Other things being equal, a company with larger sales can afford to invest more heavily in developing new manufacturing technologies. This is amply evident in the case of Hitachi: powered by a trebling in its sales, Hitachi's capital spending as measured by Value Line shot from $1,695 million in 1983 to $5,763 million in 1993. In other words, Hitachi's capital spending is now 182 percent of IBM's, up from just 34 percent a decade ago. As Hitachi and IBM pay the same prices for high-technology manufacturing equipment, Hitachi's success translates directly into a real advantage on the factory floor.

Moreover, Japanese corporations are now better placed than ever to innovate. Thanks to the high yen, they can comfortably pay top dollar to engage more and more of the West's best scientists, industrial designers, inventors, and software writers in creating the products of tomorrow. We will be seeing the fruits of this effort on Main Street in the second half of the 1990s.

And the high yen enables the Japanese economic system to make friends everywhere money talks. Corporate Japan can now wield vast public relations budgets to influence Western scholars, authors, editors, publishers, lawyers, management consultants, and investment bankers. Japan now outspends the United States in foreign aid in many countries, including parts of the former Soviet bloc. In this sense, the prominent Japan scholar Chalmers Johnson is right to say that it was Japan, not the United States, which won the cold war. Certainly foreign aid is a key lever of global politics, and it ensures that when the chips are down many nations in the Second and Third Worlds generally side with Japan in international disputes. And as the dollar declines, Japan can buy political favors in foreign capitals with the same ease with which corporate America did in the great days of American leadership in the 1950s.

Even more troubling for Americans, every increase in the yen brings nearer the day when Japan will surpass America to become the world's largest economy. And if Japan passes America, it will soon take over the leadership role America has long enjoyed in setting global rules on trade and other economic matters.

The dollar's decline dramatically raises the price of America's imports of manufacturing equipment — a crucial point given that American industry is now highly dependent on Japan, and to a lesser extent Germany, for the advanced machines needed to boost America's manufacturing productivity.

Seen from a Tokyo vantage point, the degree of self-delusion prominent Americans displayed in underestimating Japan's strength in the early 1990s was clear evidence that the United States is incapable of taking even the first step toward restoring its ability to compete with Japan. That first step is to remove the blinders and see things as they really are.

Japanese economics — the mystery

Japan's growth in the last half-century is unsurpassed in the history of economics. The numbers are more remarkable than even many economists realize. In 1950, Japan was only 3 percent the size of the American economy; in 1960, it had moved to 8 percent; in 1970 to 20 percent; and in 1980 to 39 percent. Japan's success since 1980 has now taken it to 68 percent of the United States. The speed with which Japan passed the United States in per capita income in the Reagan-Bush era was unprecedented in world economic history. By comparison, as the British economic historian Nicholas Crafts pointed out, the United States took more than a century to achieve a similar income gain against Britain in a time of stable exchange rates.

Japan's growth since 1980 has been all the more surprising because by the late 1970s Japan had already drawn level with or surpassed the United States in many advanced industries. Thus fifteen years ago Western economists already believed that Japan's era of economic overachievement had ended. Given that Japan is regarded as the economy that "breaks all the rules of good economics," why has it been so successful?

None of the conventional explanations comes close to solving the mystery. Japan's work ethic, for instance, explains almost nothing. The Japanese today work 228 fewer hours annually than they did twenty years ago. Meanwhile, as the Harvard economist Juliet B. Schor explained in *The Overworked American* in 1992, Americans have actually increased their hours by 160 hours in the same period. Thus, had the work ethic been the pivotal factor, America should have noticeably outperformed Japan in recent years, not the other way around.

Many in the West regard Japan's high-quality products and skilled work force as key factors in Japan's success. But the world's currency markets are supposed to realign currencies automatically to adjust for such differences in national performance. In this case, this would have meant that a higher yen should long ago have weakened Japan's export prowess.

Reaganite commentators in the United States have attributed Japan's success to low tax rates — but this is a classic example of how influential Americans misinterpret the facts of Japanese economics to suit their own theories. The truth is that Japan's tax rates are higher than America's — not only for corporate profits and executive salaries but for most investment gains.

Another explanation often advanced by American economists is that Japan's trade surpluses are caused by Japan's high savings rate. This begs the question of why the Japanese save. Economists unfamiliar with Japan are content to ascribe the pattern to "culture." Yet economic historians know that the Japanese people have no deep-seated tradition of frugality. Japan's super-high savings rate emerged only after the American occupation of the country ended in 1952. In the subsequent eight years the rate of total net savings nearly doubled, rising from 10.2 to 18.2 percent. Why? In truth, this is one of the most significant untold stories of Japan's miracle economy.

The Yale historian Paul Kennedy has argued that Japan has been "free riding" under America's defense umbrella and thus has been able to outspend America in industrial investment. At best, this provides only a small part of the story. For one thing, Japan's defense spending is not as low as it seems: official international comparisons understate Japan's true defense burden by leaving out such notable items as military pensions. In any case, Kennedy's theory is contradicted by the evidence of Korea and Taiwan. They both spend massively on defense — proportionately, far more than the United States — yet, using Japanese-style economic policies, they too have consistently boomed.

A related theory holds that American defense spending has weakened America by diverting too many of America's brightest scientific and engineering brains away from consumer manufacturing. But this views the problem in too narrow a focus. There is no absolute shortage of bright Americans — only a shortage of incentives for them to pursue careers in consumer manufacturing. By comparison, the incentives are greater not only in the defense industry but in myriad service activities such as law and finance. Japanese students are twice as likely as their American counterparts to study science or engineering because, unlike in the United States, these disciplines put young Japanese on the fast track to the boardroom. As Americans contemplate Japan's surging technological exports, the mystery to ponder is why America's free market system persistently underrewards industrial scientists and engineers.

Some people say Japan is doing well not so much on its own merits but because America is mismanaging itself. This can hardly be the key factor because countries such as Germany and Switzerland are now finding it almost as difficult as America to compete with Japan — yet they are largely untroubled by low savings, poor schools, and the other tribulations of late-twentieth-century America.

One of the most amazing things about the Japan story is that it has been almost completely ignored by conventional Western economists. In fact, top Western economists seem instinctively to shrink from Japan — as if they recognize that Japan poses a fatal threat to their deepest beliefs. Despite Japan's record of growth, no student of Japanese economics has come away with any insights that might merit the Nobel Prize. In fact there have been practically no insights that merit even a footnote in standard American college textbooks.

Public comments by American economists on Japan are often embarrassingly ill-informed. In the 1970s, for instance, Nobel Prize–winner Milton Friedman attributed Japan's success to the supposed especially *free* nature of markets in Japan!

Although hundreds of scholarly books on Japanese economics are published each year, most consist of narrowly focused essays, each written by a different essayist who has typically spent just a few weeks in Japan as a guest of the Japanese authorities. Such books are full of unresolved internal contradictions. The sum total of the American economics profession's work on Japan is a Tower of Babel.

The West's most influential economic publications have hardly been a beacon of light either. They keep contradicting themselves about many of the basic facts of Japan. Is Japan an unfair trader? After thirty years of mulling the evidence, the *Wall Street Journal* is still scratching its head. Sometimes it accuses Japan of a massively coordinated effort to dump products in foreign markets. Sometimes it says no such campaign exists and anyone who thinks otherwise is a despicable conspiracy theorist!

The *Economist*'s coverage of Japan has also been perplexing. All through the 1970s and 1980s, the *Economist* argued that Japan's market-defying economic policies were "bad economics." Recently it has quietly shifted its ground. It now argues that Japan's "bad economics" was probably effective in the past but is somehow no longer effective today. But what has changed? The magazine's embarrassed editors have never frankly addressed this question. The truth is, as we will see, Japan's controversial economic policies have always been highly effective. And once one understands why they work, one sees that in the future they will be even more effective than ever.

Japan's many trade barriers are the best-known example of its "bad economics." Then there are the *keiretsus*, Japan's groups of financially interlinked companies that trade in cliquish ways. Other examples abound: Japan's lifetime employment system, its strict seniority promotion system for corporate employees, its cartels, its ubiquitous government interference in the economy, its strange land policies that artificially restrict people's living space, and its tight financial regulation. All are, in the language of Western economics, "rigidities." They interfere with the workings of the market and are therefore condemned by Western economists as hindrances to economic efficiency.

Some conventional economists have concluded that Japan's peculiar economic arrangements are cultural hangovers from the days of the shoguns, the military dictators who ruled Japan until 1868. But for these "feudal dysfunctions," they have argued, Japan would have been even more successful. This was always an unlikely theory and it has become untenable in recent years as Taiwan and South Korea succeeded spectacularly in emulating Japan's growth soon after they copied many of the "rigidities" of the Japanese economic system. Clearly East Asians know something Westerners don't. But what?

To solve the mystery, we must start by reevaluating the basic principles of Western economics.

Sayonara, capitalism

Economics is an evolutionary science. Economic ideas are not sacred principles carved in stone, as economists like to suggest, but merely inferences drawn from observing man's constantly evolving efforts to create wealth. Thus economic ideas need to be re-evaluated whenever the pattern of man's economic activities undergoes significant change.