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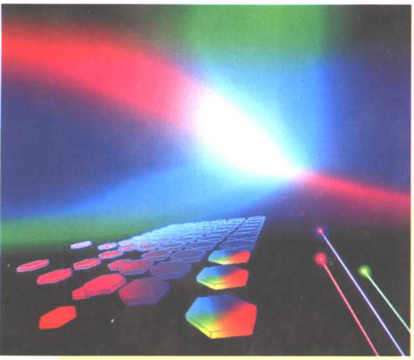
The Japanese Market Economy System: Its Strengths and Weaknesses

Tsuru Kotaro

Former Deputy Director

Policy Division, Economic Planning Agency



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Transcription of names

The Hepburn system of romanization is used for Japanese terms, including the names of persons and places. Long vowels are not indicated. Chinese terms are romanized using the pinyin system. The Wade-Giles system is used, however, for certain place-names outside mainland China. As for the romanization of Korean terms, the McCune-Reischauer system is used.

With regard to Japanese, Chinese, and Korean personal names, we have followed the local custom of placing the family name first.

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Preface to the English-Language Edition

It is indeed a great joy that, thanks to the efforts of the LTCB International Library Foundation, my book *Nihon-teki Shijo-Keizai System* (The Japanese Market Economy System) has been translated into English and thus made available to foreign readers. As I emphasized in the preface to the Japanese edition, this book aims—through the use of universal tools and terminology—to explain Japan's market economy system from a perspective which is as objective and impartial as possible. I am, therefore, hopeful that foreign readers will be able to read the book without feeling that the subject matter is inscrutable.

The evaluation of the Japanese market economy system has changed greatly during the past several years, both at home and abroad. During the latter part of the 1980s, which was a peak period for the Japanese economy, much was said with envious admiration about the nation's economic system being the source of the dynamism which was then permeating the Japanese economy. In the 1990s, on the other hand, against the backdrop of the severe recession following the bursting of the bubble, the Japanese market economy system has been seen as the fetter inhibiting the long-term development of the economy. Calls are even being heard at home seeking the fundamental reform of the economic system.

Since the publication of the Japanese edition of this book over a year and a half ago, the tempo of the Japanese economy has been slow, although there have recently been early signs of recovery. There is currently an air of anxiety about the future of the Japanese economy amid the progressing aging of the population and hollowing of domestic industries. The employment situation is becoming more severe, and it seems that the system of employment is shifting from a seniority-based structure to a more merit-based system to a greater degree than we had anticipated. Moreover, the harmful effects of the Japanese system of public policy administration—which is discretionary, relationship-dependent, and oriented towards *a priori* problem avoidance (see section 5 of chapter 6)—are coming to the surface all at once. This has been revealed in the government's recent handling of the problem of housing loan finance companies (so-called *jusen* in Japanese), with the problem having been aggravated by the government's procrastination in arriving at a fundamental settlement.

However, it is also true that the evaluation of an economic system is influenced by short-term economic developments. In this sense, the optimism of the late 1980s and the pessimism of the 1990s are both excessive. That is why it is important to analyze the economic system with a "cool head" from the three viewpoints of theory, history, and international comparison so as to have an outlook for its future. That is the approach emphasized in the book.

An economic system is like a piece of music. Just as it makes little sense to ask which piece of music is superior, what constitutes a good economic system changes according to the various conditions of the period and the country. At the same time, the economic system itself can change in an evolutionary manner.

I hope this book will not only provide the foreign reader with a balanced view of the Japanese market economy system but also help promote further interest in the Japanese economy.

Let me take this opportunity to thank the many individuals who have been involved in the production of the English edition of the book. Especially, I am grateful to Messrs. Uehara Takashi (executive director) and Miyado Yoshio of the LTCB International Library Foundation for initiating the project. I am also grateful to the staff of Simul International for their careful and efficient work through the entire process of translation and production, despite the inconvenience caused by my being away in a foreign country.

March 1996

Preface

The Japanese Market Economy System: Its Strengths and Weaknesses

The Japanese economy is about to change. An economy is a "living thing" and as such projects different "expressions" reflective of different periods. However, isn't what we are lately feeling in business and in our daily lives a "structural" change progressing beneath such exterior changes? That is, it seems that more and more we often feel a change taking place in the mechanism that has heretofore supported the Japanese economy. These changes seem to be against the economy's recent ins and outs characterized by the long expansionary phase of the latter half of the 1980s, the subsequent recession, and the emergence and burst of the bubble.

The system of the Japanese economy itself has begun to change largely because of the heightening sentiment that the existing system needs to be reassessed.

First is "foreign pressure." In a look at the history of economic friction with the United States, for example, we find that the source of friction has shifted from such "products" as textiles, color television sets, and automobiles in the 1970s to the treatment of foreign lawyers and other issues related to "services" in the 1980s and to such issues as *keiretsu* and the distribution industry, which are related to the "system" itself in the U.S.–Japan Structural Impediments Initiatives talks of the late 1980s. Japan's business practices have especially become a target of criticism as a factor limiting the openness of its market.

Second, questions have been raised within the country itself. In particular, from the standpoint of workers, long working hours and frequent deaths associated with them have created the term "company men," calling for the need to escape from a company-centered society. This awareness has received added strength from a proposal by Morita Akio, chairman of Sony Corp., that the Japanese corporate system should be revised from the standpoint of management. (See his article in the February 1992 issue of *Bungei Shunju.*)

Third, the so-called regime of 1955 collapsed. With the end of a 38-year political domination by the Liberal Democratic Party, an occasion was provided to reassess the total system of Japan, which was maintained throughout the postwar era. Concurrently, the global transition of communist countries to market economies has increased the awareness about how capitalism, or the market economy system, should function.

With currently increasing calls for reassessment of the Japanese market economy system are heated discussions about Japanese-type capitalism. The arguments that have so far been put forth can be broadly classified into two types:

The first is based on the notion that Japan is unique. For example, some have discussed the origin of the Japanese market economy system from the sociological and anthropological points of view by using such concepts as *ie* (family) and *mura* (village). And some have said that the Japanese system is unique, one created by the government to catch up with the United States and Europe. Both positions focus on the backwardness of the Japanese system.

The second argument stresses the economic rationality of the Japanese-style economic system by applying recent theoretical developments in economics, including the economics of information, of incentives, and of game theory. This position focuses on the universality of the Japanese market economy system.

From the point of view of the first line of argument, we must abandon the existing system and construct a new one. But this is too one-sided. On the other hand, the second line of argument holds that analyses of the Japanese market economy system have been yielding productive results. However, this point of view has often suffered from a tendency to limit its analysis to specific areas or to overstress the merits of the system.

As with human beings, what appears to be a strength of the market economy system can also be a weakness. Just as no one has a perfect personality, no market economy system is perfect, having both merits and demerits. It is an existence always in pursuit of a better system, searching and progressing. To evaluate the Japanese market economy system more objectively, this book uses the above-mentioned theoretical framework to make an international comparison of the market economy systems of Japan, the United States, and Europe from various standpoints to clarify the "lights" and "shadows" of each. It will then indicate the direction in which the Japanese market economy system might be heading.

This book was born of involvement in the writing of the *Economic Survey of Japan,* which is a kind of White Paper on the Japanese Economy, in my capacity as a staff member of the First Domestic Research Division of the Economic Planning Agency's Research Bureau from September 1991 to July 1994. I am especially indebted to Kojima Shoichi, councillor in the Planning Bureau, who gave me the opportunity to make a comprehensive treatment of the market economy system in the *1991 White Paper*, and to Komine Takao, former director of the First Domestic Research Division (currently councillor in the Regional Development Bureau of the National Land Agency), who encouraged me to write this book and who meticulously read through the manuscript. Both gentlemen have taught me a great deal. Professor Aoki Masahiko of Stanford University advised me in several ways and helped me to better understand the issues related to the market economy system during a visit with him in conjunction with the writing of the *White Paper*, and I wish to thank him for his great assistance. I well recognize that the author alone is responsible for any remaining errors. It should also be made clear that the views and opinions expressed in the book do not represent those of the organization of which the author is a member. Specific analyses in the book are the cooperative results, produced in the process of the writing of the *White Paper*, of the staff members of the First Domestic Research Division, to whom I also express my thanks.

In the process leading up to the book's publication, I received sizable assistance from Suzuki Shoichi of the Cultural Publications Division 1 of Kodansha Ltd. Publishers (he is currently deputy editor of *Views*). I thank him especially for his constant encouragement when I was behind schedule in writing, which often happened.

CONTENTS

Introduction: How to Understand the Japanese Market Economy System

The market economy system is a broad concept. Furthermore, it is closely related to the overall political and social system, of which it is a part.

For example, we may be able to think of two broad types of economic systems, namely, the "centralized economic system" found in the former communist countries and the economic system based on the market economy ("market economy system") found in countries of the free world. In the first, decisions about prices and resource allocation are made centrally by the government. In the other, however, prices and resource allocation are determined by the market mechanism (the so-called invisible hand of Adam Smith). A large difference therefore exists between the two systems.

But even within the market economy system, the topic of this book, we observe clear differences between (1) Japan; (2) the United States, the United Kingdom, and other English-speaking countries; and (3) Germany, France, and other countries on the Continent. In the introduction, let us discuss the perspectives and analytical frameworks needed to make an international comparison of market economy systems and to clarify the characteristics of each.

THE MARKET ECONOMY SYSTEM VIEWED FROM ECONOMIC THEORY

Problems with the approach of traditional economics

First let us see how the market economy system is understood by traditional (neoclassical) economics. The following general equilibrium model is found in textbooks on microeconomics.

(1) The principal players in the market economy are consumers and firms. They are both homogeneous and infinite in number.
(2) Households and firms are price takers (to which prices are given), and they both maximize either utility from consumption or profits from production and sales.
(3) A competitive equilibrium results, and optimal allocation of resources is achieved.

We must say, however, that this simple model is inadequate to explain the characteristics of the real economic system, although it may be a starting point of analysis. There are several reasons for this.

First, the number of firms in reality is finite. In some markets the number is few and the firms have significant price-setting power. Thus the result is a problem of not being able to achieve optimal resource allocation (the problem of oligopoly and monopoly).

Second, general equilibrium models assume that all transactions take place efficiently in a frictionless market. In reality, however, market transactions have various kinds of cost; thus it is unreasonable to believe that they are always conducted efficiently. For example, general equilibrium models implicitly assume that households and firms can obtain at no cost all information necessary for decision making related to market transactions. However, market transactions are not necessarily conducted smoothly in situations with informational asymmetry between transaction parties, such as when households have less information about product quality than companies do.

Third, while the household consuming agents maximize their satisfaction (utility) through consumption, a serious problem remains: For whom do the firms supposedly maximize profits? In traditional economics, a firm is owned by shareholders (capitalists) and its role is to maximize its value, or its stock value. In reality, however, it is difficult to accept firms being managed only for the benefit of shareholders. Several conceivable patterns of relationship exist between the firm and its various stake holders.

Fourth, if the number of firms is finite, the decision making of each about pricing, production, and market entry critically affects the decision making of other firms. That is, the interaction between the behavior of one and that of another becomes important. Moreover, although market transactions of households and firms are assumed to be one-time transactions (spot transactions), market transactions in reality are carried out on a long-term basis as long as the firms exist. Thus it is more appropriate to think that the decisions of households and firms are also made from a long-term standpoint.

The fifth reason concerns the role of company technologies, which also has significance for the economic development of a nation. In general equilibrium models, technology is expressed as a production function. That is, such factors of production as capital and labor are placed as inputs in the production function, with production being the output. The production function, however, is strictly a "black box"; thus we cannot analyze how the firm's technology is influenced by corporate organization and the surrounding environment and how this technology evolves over time. To explore the characteristics of the market economy system, the contents of the "black box" must be examined.

Seen in this manner, the prototype market economy system, as shown in a textbook-style general equilibrium model, does not necessarily function effectively in practice. It is thus necessary to think of a different type of market economy system to find solutions to the problems that may arise in it. Moreover, when a market fails and resources are not allocated optimally, the role of the government as the third player becomes important in the market economy system.

The emergence of a new analytical framework

Although the traditional general equilibrium theory had been the mainstream of economics until the early 1970s, microeconomics began to change drastically in that decade, given an increasing awareness of the problems mentioned above.

First, we find the development of the economics of transactions cost, the origin of which can be traced to an article, "The Nature of the Firm," published in 1937 by R. H. Coase, 1991 Nobel Laureate from the University of Chicago. According to Coase, market transactions may not take place efficiently because of the transactions cost (the cost of decision making, planning, and negotiations in market transactions). Economic activities should be conducted to minimize this cost. This determines whether a market transaction is conducted through the market mechanism or within the firm. When market transactions have a high transactions cost, intrafirm transactions can reduce it. Coase argued that this role constitutes the character of the firm. The significance of the economics of transactions cost is that it has clarified the economic rationality of transactions not effected through the market mechanism (a response to the second problem listed above).

Second was the revolutionary development of the economic theory of information and incentives as well as game theory after the 1970s. The economics of information and incentives has made it possible to analyze the issues related to the contracts and transactions between economic agents by stressing the problem of information (presence of informational asymmetry) and the role of incentives for economic agents (a response to the second and third problems, listed above). The development of game theory has built up the foundation for understanding the behavior patterns of economic agents by explicitly considering their intertemporal settings and interactions between the behavior of one agent and that of another (a response to the fourth problem). These branches of economics have thus provided us with strong tools to analyze what has been overlooked in traditional models. As the economics of transactions cost, the economics of information and incentives, and game theory have developed by exerting influence on one another, it is difficult to strictly differentiate them.

The general reader may be unfamiliar with these new branches of economics. However, they may be far more accessible than traditional microeconomic theory because they provide a contact with real-life issues. In this sense we have a fair amount of basic tools necessary to analyze the actual market economy system. Active research is now taking place under the leadership of Aoki Masahiko of Stanford University to make an international comparison of market economy systems against the background of these theoretical developments.

THE ANALYTICAL APPROACH OF THE BOOK

Analysis focused on the firm

Because of these recent developments and the achievements of economics, this book will clarify the characteristics (merits and demerits) and problems of the Japanese market economy system by analyzing its many facets as comprehensively as possible. Here I wish to point out the objects and the methodologies of analysis.

To begin with, let me mention a few things concerning which aspects of the system we will focus on in our analysis (that is, the objects of our analysis).

First, we must define the market economy system. To analyze it, we must first clearly define it. Unlike the traditional view of the market economy, this book takes the stance of clarifying the characteristics of the market economy system by stressing the mutual relationships between economic agents and assumes that the market economy system is a nexus of "organic connections among its constituent members, such as firms, consumers, and government."

Second, to analyze the characteristics of a specific market economy system, the book will place the firm at its center. This results from the belief that the diversity of market economy systems is greatly reflected in the relationship between the firm and its various stake holders (fig. 0-1). They may include (1) shareholders, (2) creditors (such as banks), (3) employees, and (4) transaction partner firms with which it maintains vertical relationships (suppliers of parts in the upstream; distributors in the downstream). Moreover, according to the Coase-type line of rea-