



The Japanese Economy in Institutional Transformation

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Theme of my talk today

- I would like to make a “big” talk today rather than speak on a specific subject such as banking crisis, fiscal system reform, etc.
- The subject matter is how to understand and characterize the changing state of Japan’s political economy, using a comparative institutional analytic approach.
- I will challenge conventional views, claiming that Japan is in the process of gradual, but fundamental institutional transformation.



Conventional views

- Internationally: Japan are caught in unprecedented liquidity trap due to slow and indecisive government action to resolve the massive non-performing loan problem (Necessity of inflation targeting policy: Krugman, Barnanke, etc.).
- Domestically: psychological perception of “the lost decade” (1.4% growth in the 1990s). Political rhetoric: “structural reform” vs. “resistant power”.

An alternative view:

institutional transformation

- Challenging questions:
 - Are there right (purely-economic) policies that can cure the Japan problem?
 - Why cannot politics react to the problem swiftly? Are politicians bad? Does the bureaucracy still retain power?
 - Are Japanese industries and firms stagnant all alike?
- An alternative view: institutional transformation (not transition!): old institutions that worked well in past have become obsolete, and are adapting to emergent situations. But this process is slow and often tacit because of the nature of institutions and resistance of vested interests.

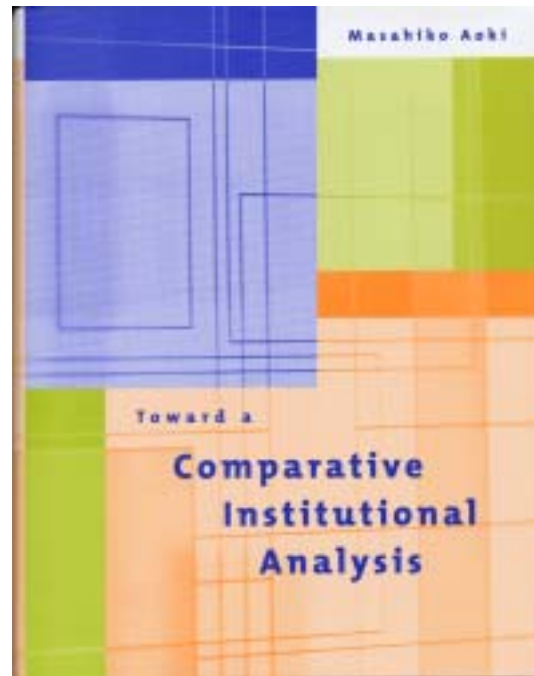
What are institutions?

- Shared beliefs in ways how the game is being repeatedly played
- Pre-set (exogenous) rules of the game conditioned by history, law, technology strategic interactions among players including the government stable equilibrium outcome (strategies) of the game emerges= this is an institution!
- Examples: life-time employment, main bank system, keiretsu, bureaupluralism (below).

Process of institutional transformation

- External shocks (technological, international, demographic, etc.) to system
- Some players (at peripheral) start to experiment, while others try to conserve vested interests.
- Either of them will eventually become dominant (stagnant or evolution). Politics and public discourse may provide a focal point for change.
- Please see M.Aoki, *Toward a Comparative Institutional Analysis*.

For analytical framework, please consult



Three shocks

- IT Revolution
 - Value of sharing of tacit knowledge between fixed partners declined = source of J-competitiveness in the 1970 and 80s.
- Borderless economies
 - Rising industrial power of China. Deflationary pressure? Good or bad for Japan? (later discussion)
- Demographic change
 - Shrinking labor force (labor force will peak in 2005 and decline at 0.5% thereafter, which will reduce GDP by 0.3%)

Impacts of IT Revolution

- packaged and in-house software production excluded from count of investment in GNP statistics of Japan; hedonic price index to account for continual quality improvements of semiconductor has not been used adjusted by Jorgenson and Motohashi (RIETI DP)
 - Investment 1%, growth rate 0.7% underestimated. TFP comparable to US
 - difference between J and US mostly in labor inputs
 - most advanced broad band and cellular telephone technologies are implemented quite recently



Impact of IT: Modularity

- Complex system can be constructed evolutionarily by variable combinations of quasi-independent modules under certain design rules (interface rules, infrastructure). Each module can be improved independently of others, and system innovation can evolve through ex post selection of improved modules (option values and tournament incentives).
- Digital technology provides broad infra-structure, while small sophisticated organizational modules becomes viable.
 - Examples: Silicon Valley cluster (“modular clusters” –Clark & Baldwin, *Power of Modularity*). 青木昌彦：模块时代

Impacts on J-industries

- Traditional Japanese approach (TJ): improve the system through continuous coordination among relational partners
continuous association of people is essential = life-time employment, keiretsu, etc.
- However, under emergent environment, organizational diversity may be more desirable.
 - Auto: TJ OK (technological complementarities and externalities among parts are strong).
 - Computing and communication systems: TJ out-of-dated, because digital technology facilitates modularization (NTT, large computer vendors, large banks).
 - Some notable innovation in retail and home-delivery services (entrepreneurial mixing of modular and TJ approaches) .
 - Emerging new ‘soft’ industries next



Emergence of soft industries

- *Manga, anime, figures, food, entertainment, fashion, ad, etc.* Fusion is a characteristics (**diversity and modularity**). Cultural exports to US were 5 times of steel exports last year, have tripled over the past 10 years to \$12.5 billion, while manufacturing exports have increased by only 20%.
- “From GDP to Gross National Cool” (McGray, *Foreign Policy*), “Cultural super power” (*Time*)

Institutional complementarities and diversity

- “National” political, social, economic and organizational institutions are mutually reinforcing = **institutional complementarities** institutions tend to become uniform and robust.
 - Life-time employment, keiretsu, main bank system, (bureaucracy).
- How can then organizational diversity possible?
 - Financial supplies become diversified and information is available in cyberspace so that national institutional constraints are relaxed.
 - Decline of organizational loyalty under mid-40s (exits of the under-40s from bureaucracy, banking, big e-firms and shortening span of employment among the youngsters).
- One institution that remains national = the nation state.
 - Footnote-like remark: search of a stable global political order? (security risks from non-state organizations such as alquaida and various reactions such as American neo-conservatism; regional order such as EU, global NGOs. Etc.).

J-political institution at bay

- Outcome-sharing within and across organizations vested interests of incumbents protected by interest group associations.
- Parallel triangular collusions among interest groups, bureaucracy, & politicians (originally “iron triangle” in strategic industries more inclusive populist approach by Tanaka (田中) = **bureau-pluralism (BP** or compartmentalized pluralism)
- Root cause of banking crisis and government deficits is inertia of BP.
- Weakening of interest groups (see the table).

Weakened interest groups

Interest group association for	number of votes in 2001	number of votes in 1980
postmasters	47	103
war veterans	29	99
contractors	27	174
war bereaved	26	92
doctors	22	83
farmers	20	116
small businesses	19	
nurses	17	52
pharmacists	15	
dentists	10	93

Change in the form of the state ?

- Potential inter-generational political conflicts: massive government deficits (not sustainable beyond 2020) and the crisis of social security system
 - Reforms in taxation, spending mechanism, social security system as well as the centralization of fiscal policy-making and decentralization of budgeting and expenditure controls are necessary (cf. on-going RIETI project)
- This will require a fundamental change in the form of the nation state, i.e., changes in relationships among bureaucrats, cabinet, political parties, interest groups and voters-cum-taxpayers.



Whither to?

- Japan entered the process of institutional transformation in the early 1990s:
 - The end of LDP one-party rule; burst of bubble and the demise of the main bank system as a core institution; impacts of IT and globalization (recognized erosion of competitiveness and emergence of 'soft industries')
- Whither to? Anglo-American model? Modified BP model? Balanced inclusion of diverse organizational models and participatory competition in politics?
- Trial and error in the domain of public policy is possible through electoral change of government. Watch out!



Conclusion

The process of institutional transformation is **gradual** (it may take one-generation), and its direction is not clearly drawn. But it is certainly at work!

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Thank you for listening.
Comments welcome.