Recent Difficulties in Japan's Economic Development (*)

Various sorts of difficulties have emerged in the present phase of Japan's postwar economic transition. Some are stubborn residual aspects of the poverty Japan has sought to transcend in a generation of "miraculous" economic growth. Some are unresolved lags in the process — having made a positive impact at one point, they come to exert a negative influence at a later stage. Some difficulties are internal; some are external; some are at the micro, some at the macro level. Some difficulties appear in the form of structural disparities, others in the form of asymmetries, constraints or bottlenecks to further growth. Some are cyclical, some secular. To a substantial degree, moreover, Japan's present difficulties express in one way or another the increasing instability of her economy and its recently rising dependence on international trade.

1. Domestic Foundations of the Economic "Miracle"

Japan's achievement during 1959-66 of an average real rate of growth in GNP of more than 10 per cent annually must be appraised first in relation to the small base upon which it began. In terms of per capita income, which most clearly reveals the size of this base, Japan ranked only about 20th among all other countries even by 1967, as compared with her rank of fourth (behind the U.S., U.S.S.R., and West Germany) in aggregate GNP output during that year. Looking at the annual rates of aggregate growth, their increasing instability can be seen from the fact that the mean deviation for the first half of the period 1959-66 was 2.0 per cent as compared with 3.8 per cent during the second half. That Japan's growth has been unbalanced is obvious first by simple inspection of her social and economic infrastructure, Tokyo, for example, containing one-tenth of the country's population, has inadequate roads, inadequate means of public transportation, and insufficient telephone service; it has an inadequate sewage system and inadequate means of garbage disposal. Schools, parks, playgrounds, and hospitals are also seriously deficient. Housing is enormously in arrears. In 1964 the city had a serious water shortage. It also has severe air and water pollution problems.

In contrast with these lags, the private sector, spurred by investment in plant and equipment, constitutes the leading sector in Japan's advance along the path of unbalanced growth. Although in her modern period Japan has always been dependent on the world at large, the sources of postwar growth — its mechanism and conditioning factors — are to be found primarily within her own domestic economy. The economic miracle has indeed been indigenous. As a result of the way in which growth has been achieved, however, its mechanism is likely to be less effective in the future, while at the same time Japan's dependence on the world economy is now greatly increasing. In the meanwhile, the degree of economic instability has likewise greatly increased.

At the outset, the role of investment in plant and equipment has been stimulated both by the dynamics of oligopoly rivalry and by government planning which sought to hasten the day when Japan would be recognized as an "advanced industrial nation". The chief oligopolists are the well-known zaibatsu-successor groups, including Mitsubishi, Mitsui and Sumitomo. In association with their respective banking sponsors, each group strives to maintain its relative position in terms of market shares. Effective competition, however — especially in the heavy and chemical industries which are the bearers of advance from the traditional to the modern era — requires vast plant capacity to reach optimal levels of scale. In order to achieve these levels, individual oligopolists may feel impelled to gamble on expansion of plant capacity far beyond the immediate...
range of realized market demand (1). Thus simultaneous installation of new plant capacity of the indicated minimum size by rival groups may create a great amount of excess capacity. At some stage of the business cycle, the repercussions of supply-leading expansion may stimulate enough new demand to justify the original speculation.

When excess capacity prevails, however, it cannot be seen in terms of the usually available statistics, because as published (see *Tōyō Keizai*, International Trade and Industry Statistics, Ministry of International Trade and Industry) the data are expressed in terms of an index number whose base is not evaluated in absolute terms. In Tokyo, however, I was able to obtain the results of an unpublished survey performed by MITI which provides the actual rate of operation in 1960 which is used as the reference point for the of operation in 1961. The survey shows that in 1960 total manufacturing industry in Japan was operating at a rate of only 81.2 percent of capacity. In 1964, at the height of a feverish boom, it was operating at only 84.4 percent of installed capacity.

That such an intense rate of fixed investment has been possible in a country so short of capital as Japan is one of the chief features of the economic miracle. In order to increase employment in areas of higher productivity, government planning called for a shift of Japan's resources from the backward sector to the advanced sector of the dual economy. The advanced sector was itself vulnerable to invasion by foreign capital in accordance with the new rules of import liberalization. But by utilizing the rivalry of various oligopolies the government could encourage the installation of modern plant capacity under domestic ownership, in a measure possibly sufficient to forestall the domination of the home market by foreigners.

Investment by business — especially big business — has received government encouragement in various direct and indirect forms such as subsidies through the tax system, subsidies through the import licensing system, and low-interest loans (available to "key" industries (2) through semigovernmental institutions such as the Japan Development Bank, the Japan Export-Import Bank and the Japan Long-Term Credit Bank). Through the acquiescence of the Bank of Japan, which supports the activities of the city banks, big business also has privileged access to commercial loans. The relevant phenomena in this context are "overloans" on the part of the city banks (whose loans and discounts usually exceed the total amount of their deposits) and "overborrowing" on the part of business. By the end of Japanese fiscal year 1967, the net worth ratio of Japan's major business firms had deteriorated to 17 percent, according to an estimate of the Ministry of Finance (3). Both business and the banks, therefore, are highly vulnerable and potentially unstable. For both, this is compounded by the fact that it is common practice

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(1) Speculative plant expansion in turn stimulates other types of speculative activity, contributing to economic instability.
(2) These include steel, shipbuilding, shipping, automobiles, machine tools, electronics, petrochemicals, and synthetic textiles.
for short term credits to be sunk in the form of fixed investment—
a practice based on the assumption that loans will be renewed (4).
Some of these loans have been borrowed from abroad and constitute
as well a claim against the meager foreign exchange reserves of the
banking system (5).

Speculative financing, rivalry for market shares, and defensive
modernizing of plants in anticipation of capital import liberalization
had the cumulative effect of prompting investment for further invest-
ment as well as for final output. This generated a boom based
essentially on long-term rather than short-term expectations and on
domestic rather than on foreign market incentives. Much of the
recent boom has been described as "profitless prosperity" (6). Indeed,
forces tending to maintain output even when profits are low or
negative have been an important feature of Japan's postwar growth.
For example, in addition to the supply-leading phenomenon, the
heavy preponderance of fixed cost within total cost also reinforces
the tendency to maintain output during recessions. Besides interest
on debt, labor often constitutes a fixed cost due to the life-contract
system of employment (7). And since they have to be paid regardless
of the state of business, workers are generally kept busy even
during recessions. Given, therefore, that variable costs are low, and
that in a tight money situation sales will occur when price
is at almost any level above variable cost, the total effect is that of
a mechanism remarkably designed to promote output under all
circumstances (8). This mechanism masks the instability which some
of the institutional arrangements described above impart to the
Japanese economy. Moreover, the tendency for firms to expand
output even in times of recession makes the amount of residual
excess capacity even more grave a matter than it otherwise would be.

2. Supply-Oriented Exports

It is evident in the relation between the structure of produc-
tion and the structure of foreign trade, forces making for in-
stability in the domestic economy have repercussions at the interna-
tional level as well. In a detailed analysis performed in terms of
the ratio of value added in domestic exports to total value added in
manufacturers' shipments within individual industries, I found that
in the prewar as well as the postwar period producers have had a
marked preference for sales in the relatively sheltered home market
rather than in the foreign market; for in the latter the need to meet
internationally competitive prices means lower profits. (Also the
domestic distribution channels of oligopoly producers are more
"orderly"— that is, more subject to preemption and control — than
are those abroad.) Despite the fact that the quantity of exports
practically quadrupled during the decade prior to 1961, Japanese
industry in the postwar period became less, rather than more, export-
oriented. The domestic boom was the principal ingredient of the
growth rate; although exports increased in size they decreased in
proportion to the national income (9).

I have found, furthermore, that a very low correlation exists
between increases in exports and increases in productivity in both
the prewar and postwar periods. This is consistent with the hypo-
thesis that in general innovations are developed — or imported —
primarily in response to opportunities in the home market. At the

(4) It may be correctly assumed that the government does not intend to allow wholesale
bankruptcies, especially among major firms. However, during the recession of 1950 there
were some substantial failures, including the Sunware Company, the Sanyo Steel

(5) In a series of articles over the past decade, the London Economist has repeatedly
emphasized what it refers to as the "universal lesson" of Japanese policy, both for Britain
and for less-developed countries. (September 1, 1962, p. 793; May 27, 1967, p. x.) It may
be doubted, however, whether some of these critical observations of Japan's performance
could be recommended to many other countries.

(6) Even in the iron and steel industry, which is in the vanguard of those industries which
have achieved economies of optimal scale, was in the theory of a profit-maximizing expansion of output
that was achieved, it would seem that the
by mid-1961. In view of the low net worth ratios mentioned above, it would seem that the
rate of net profits in relation to net worth should be high. This ratio has in fact declined
due to the decline in profit margins on sales and on the reduction in the ratio of sales to
the sales of the nation as a whole does not necessarily rise.

(7) In 1960, exports were 13.9 percent of the national income as compared with 23.1
percent during 1936. (The Bank of Japan, Statistics Department, Historical Statistics of the
Japanese Economy, Tokyo, 1963, p. 96.) As observed below, however, a new trend is
developing in which exports are becoming vastly more important as a market for Japanese
industry.
same time, moreover, there is evidence of an association between expansion in output and expansion in exports. In particular, expansion in output leads to an expansion in exports; that is, exports seem to be impelled by increases in output capacity. I have described these elements as constituting a mechanism of "supply-oriented exports" (10).

By providing a vent for surplus output, especially during recessions, the mechanism of supply-orientated exports formerly provided a stabilizing force in Japan's balance of payments. In the postwar period, recessions have almost invariably been precipitated by tight-money policies of the government implemented as a remedy for deficits in the balance of payments (11). Ordinarily, as mentioned above, producers prefer to sell in the domestic market, but when sales are slack at home due to credit shortages they face a dilemma because of the intensified pressure of their high fixed cost obligations. In these circumstances, they attempt to quickly expand their foreign sales, often by means of price-cutting (12). The meaning of this result, first, is that a dramatic expansion of exports often provides confirming rather than disconfirming evidence of a recession in Japan (13).

(11) The recession of 1955-56 was caused by the ending of the Korean War rather than by the application of tight-money policy.
(12) Letter of credit, accompanying export sales, incidentally, may be discounted to provide early cash settlement, in contrast with domestic receivables which are much less liquid during periods of tight money. By specifically financing the production of a given export, the letter of credit provides a legitimate reason for an export price increase when the domestic price (domestic credit might be unavailable. It should not be assumed that the means for rapidly shifting from domestic to foreign sales is highly effective in Japan. A key invention developed in Japan in the form of the trading companies (Rigo sakaku) was instrumental in the attention of less developed countries, and by which those countries could well be recommended to the attention of less developed countries. These firms provide their clients with distribution facilities in all foreign domestic markets. A Japanese producer with no foreign contact or experience can simply request its trading company to dispose of its goods abroad, rather than at home. It might be added that since the trading companies are interested in rapid turnover, they have been accused of reinforcing this price-cutting on the part of firms to cut export prices during recessions. This price-cutting, then, has been plagued by a long series of "sharp" export products in an ever accelerating manner and the need for innovation of new products has become more urgent. In discussing the 1964-65 recession, some observers explain that the economy produced a growing external surplus despite the depressing factors which were always predominant during periods of domestic recovery.

Second, although improvement in the trade balance may be beneficial in a recession, achieving it by means of price-cutting creates potential instability by evoking retaliation and discrimination abroad. Third, in contrast with the past, both her increasing productive capacity and her increasing share of the world market make Japan's continued reliance on supply-oriented exports a destabilizing one, rather than stabilizing aspect of her economy. The heavy and chemical industries now depend on exports to absorb a substantial and increasing share of their output (14). Both from the point of view of Japan's domestic structure of production and from the point of view of her trade partners, future exports can no longer be manipulated in accordance with the emergencies of the domestic business cycle but must be planned as an established and stable component of the total market. Thus in the future Japan will no longer possess the advantages (in the past Japanese economists exclusively emphasized the disadvantages) of being a "marginal supplier".

3. Cyclical Instability

Periodic bouts of explosive domestic investment have given rise not only to the destabilizing recession phenomenon of supply-oriented exports but also to a balance of payments constraint on growth during prosperity. This constraint is steadily being tightened because the foreign exchange reserves have not increased commensurately with the growth of Japan's trade and national income. Further repercussions in the economy at large arise from what is apparently a secular trend of increase in the degree of balance of payments instability.

A typical episode in the upswing of the cycle begins with a large increase in inventories, including inventories of imported raw materials and intermediate products (15). The increasing absorp-

(14) Steel has become Japan's largest export industry. During the recession of 1964-65, exports of steel increased by 43 percent. By 1968, a recovery year in which the domestic market again took priority over exports, the latter nevertheless accounted for about 20 percent of total sales of steel.
(15) Because of the way in which investment is financed in Japan — mostly by borrowed money — efforts are usually made to keep the ratio of inventories to output as low as possible. During a business upturn, therefore, the increment in inventories is in relation to any increase in GNP is very high, probably higher than anywhere else in the world. Similarly in the downturn, accelerated inventory liquidation intensifies the degree of business fluctuation.
tion of imports furthermore has a tendency to raise their unit price. Because prices of finished goods are also rising in the domestic market, producers would rather sell at home than abroad where they are subject to the pressure of international competition. Here we see the converse of the supply-oriented export phenomenon described above. At the same time, producers are heavily stockpiling imported materials because they anticipate that restrictive measures against imports may be introduced. During the heyday of the foreign exchange control system, imports could be regulated directly by the state of the reserves, but with the advent of import liberalization it became necessary to rely chiefly on other measures, especially monetary policy.

The policy intentions of the Bank of Japan may be signalled by a change in the discount rate or by a change in the level of open market operations. Open market operations do not exist due to the undeveloped state of the bond market. Substantially, the implementation of a restrictive policy takes the form of "window guidance" (madoguchi shido), by which the Bank of Japan ration credit to its clients (16). This enables the Bank to dampen the level of economic activity both in general and selectively, with a consequent direct as well as indirect effect in reducing imports, thus relieving pressure on the foreign exchange reserves.

The most recent tight money policy implemented in September 1967 was the fifth such episode since the autumn of 1953. Comparison of these episodes reveals an increasing degree of instability in the economy, increasing restrictiveness of the balance of payments constraint on growth, and the emergence of more complex problems of contra-cyclical policy.

The increasing severity of business cycles in Japan is due to structural as well as to cyclical difficulties. These became distinctly evident in the period of overheating which culminated with the Tokyo Olympic Games of 1964. As an antidote, the government applied the usual tight money policy (first steps were actually taken in December 1963), but it was less effective than on previous occasions. Partly this was due to the enhanced liquidity of leading firms which had acquired more reserves during the previous expansion. Partly it was due to an enormous expansion in commercial credit as distinguished from bank credit. "Accommodation bills", as they are known, also impart an acute degree of instability to Japan's economic system (17).

When eventually (by the third quarter of 1964) the expansion was arrested, the following recession (lasting until the first quarter of 1966) turned out to be the most severe since the end of World War II. Inadequate as monetary policy had been to arrest the boom, it was even less adequate to re-stimulate growth after the balance of payments deficit had been corrected. A structural factor beyond the reach of monetary policy was the attenuation of the labor supply, resulting in higher costs of production (18). In addition, the burden of Japan's inefficient system of distribution has placed her at an increasing competitive disadvantage. Revival of the growth rate was also impaired by excessive vertical integration, without regard for economies of scale, which took place among rival oligopolistic enterprises (each of which desired to control all stages of production under its own management). The inefficiency of such activities contributed to the creation of persistent excess capacity in some industries (19).

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(16) In the spirit of economic liberalization, the Bank of Japan officially "abolished" window guidance in June 1965, but reintroduced it in August 1967. Bank of Japan Special No. 33, May 1968, p. 5. In effect, window guidance also constitutes a powerful tool by which economic planning may be enforced through the banking system.

(17) By the nature of the beast, accurate statistics are difficult to obtain. One species may be described as follows. Suppose I have a bill to pay, but no money. I give you my (worthless) promissory note in exchange for your (sound) promissory note. Then I discount your promissory note at the bank, which gives me the money I need. Another is the following. Suppose you want to borrow at the bank, but you need collateral. I give you my promissory note (which I warn you not to allow to come to maturity because in that event, I could be a dishonor). In which you then present to your bank (but not for discount), because in that event it would be sent back to the original bank of second which would see that I have obligated myself beyond my means as collateral for the loan you seek. The rule of the game is that the holder of an accommodation bill must never allow it to come to maturity, for in that event not only would the issuing firm be blacklisted for being obligated to discount it, but all the creditors of that firm would demand payment upon it; and it would be forced into bankruptcy.

(18) Excess labor, especially of young workers who in Japan's lengthy structure of wage scales received remarkably low pay, had been one of the key factors in postwar growth, but this has been dissipated in the recent demographic transition. On the other hand, Japanese standards of labor force utilization have something to be desired; for example, compulsory retirement at age 55 is still commonly enforced.

(19) Outlays in accordance with production quotas assigned by the Ministry of International Trade and Industry are the usual treatment for chronic excess capacity. The anticipation of these quotas, which are assigned in accordance with specified base period production, is, for the various members of an industry, help to create the very excess capacity which the Ministry attempts to correct, for each firm must build enough capacity to protect its market share in time of recession, as well as in time of boom. Provided this interesting example of structural conflict between macro and macro policy objectives.
Recent Difficulties in Japan’s Economic Development

Another development in the evolution of the business cycle was a conflict between fiscal policy and monetary policy during the upswing of 1966-67. The conflict revealed itself in mid-1967 when at the macro level of the economy pressure developed in the balance of payments while at the micro level individual firms were still in an expansive and aggressive mood. At similar junctures in the past the indicated treatment would simply have been the application of a tight money policy. In the given instance, however, government spending could not be suddenly turned off, for "budgetary rigidity" had come into play. Partly this was a euphemism for resistance to any cutback on the part of those with a vested interest in the continuation of deficit spending. Partly it was a result of the difficulty of coordinating public works projects with the requirements of monetary policy. For having accomplished its initial purpose of restimulating the growth rate, the deficit financing program had acquired a new rationale, namely, that of reducing Japan’s enormous deficit of social overhead capital and basic public amenities. The latter are notoriously inflexible in the construction as well as in the budgetary phase. In any event, the liquidity position of firms (large rather than small firms, for government deficit spending chiefly benefited the former) improved and they were less subject to control than formerly by a restrictive monetary policy.

The banks were particularly ill-pleased with their quotas for purchase of government bonds, for they reduced the volume of their loans (causing scarce funds to go from the banks to the government and thence to business rather than from the banks directly to businesses in a tight labor market. Thus rising costs are transmitted more forcibly to consumer than to wholesale prices. The inefficient system of distribution, including an excessive number of intermediaries, is another factor tending to raise consumer prices disproportionately in Japan. The cost of distribution constitutes approximately 20 percent of retail prices. Unless these factors are taken into account, the evidence of price indices is inadequate. The current state of the economy may be confusing.

(13) Contributing to the reduced effectiveness of monetary policy during this period was an increasing tendency on the part of firms to turn to financial institutions other than those subject to the Bank of Japan’s quantitative controls on loans. The controlled group includes only the 13 city and local banks with deposits in excess of 150,000 million yen. The uncontrolled group includes smaller local banks, trust banks, mutual banks, life insurance companies, savings and loan associations, farm credit unions, and foreign banks. This prompted the Bank of Japan to undertake a study of how its controls could be made more comprehensive. It might be added that the liquidity condition of firms was temporarily increased through the direct and indirect effects of United States military procurement associated with the Vietnam War.
ness), forced them to accept a lower rate of return on the bonds than they could have obtained (especially during periods of tight money from business loans), and in addition their portfolios of government bonds tended constantly to lose value since no real free market for these securities existed. This was particularly apparent when the reserve position of the city banks deteriorated under the Bank of Japan pressure the incentive for disposing of the bonds increased. However, the situation for the banks was not as bad as it might have been, for to some extent their initial purchases of the government bonds were financed by funds provided to them for that purpose by the Bank of Japan.

In addition to the strengthened liquidity position of major firms, the power of the authorities to restrict domestic demand by monetary policy has also been jeopardized by a strong secular as distinguished from cyclical increase in consumer imports, particularly of food, which is not readily discouraged. This was a factor in the decline of the merchandise trade balance by $1.3 billion between 1966 and 1967, the overall balance of payments deficit being $571 million in the latter year (24). Growing difficulties have been experienced by the authorities in applying economic brakes as dictated by exigencies in the balance of payments. This can be demonstrated by a review of recent tight-money episodes. In 1957, it took three months for business to reach a turning point; in 1961, seven months in 1964, and slightly more than seven months in the episode beginning in September 1965. The reversal of the balance of payments deficit in 1968, moreover, can be attributed principally to factors other than the tight-money policy. Exports to the United States were stimulated by the threat of an impending strike in the steel industry, by the possibility that import quotas or import surcharges would be imposed, and by the general inflationary climate of the United States in the first half of 1968. Exports were also helped by an improvement in business conditions in Western Europe. Supply-oriented exports were another important factor, resulting from modernization of facilities and large increases in productive capacity beyond the requirements of the domestic market. On the import side, the tight-money policy had the effect principally of restricting inventory stockpiling, but did not substantially reduce the level of imports for consumption.

While hitherto the proximate cause of Japanese business recessions has been the implementation of tight money policies in response to balance of payments difficulties, hereafter they may well be induced independently as a result of excess industrial capacity. Economic volatility is further intensified by Japan's emphasis on modern heavy and chemical goods output as contrasted with the declining traditional labor intensive and consumer goods industries (25). Although the cycle has become more volatile, the economy has developed more inertia and thus has become more independent of government policy both in the upward and downward phases of the cycle. The increasing length of time for a turning point to follow the implementation of tight money policies in successive cycles has been mentioned above. On the other hand, the increasing length of recessionary periods in Japanese cycles is suggested by an analysis of the Economic Planning Agency. The duration of the recessionary period around the trough of October 1953 was four months, around the trough of September 1954 it was eight months, and around the trough of April 1958 it was ten months (26). Recent experience tends to confirm this evidence of the increasing length of the recessionary phase.

4. Balance of Payments

Although in the past Japan's economic miracle was largely animated by domestic forces and conditioned by domestic institutions, she has become progressively more dependent on the international economy. Even formerly, the main immediate constraint on the growth rate lay in the balance of payments; now that the role of foreign trade is increasing, it determines this constraint in a more

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(24) The rise and inertia of private consumer demand in this context may be a factor motivating the Japanese Government to maintain and reinforce its regressive tax policy, so as to maintain its aceleration in the steady rise in consumer prices.


fundamental sense as well. For whereas in the former case the problem was chiefly one of liquidity, in the latter it is one of sources and markets.

In evaluating Japan's increased dependence, it might be observed in the first place that the volume of trade has been increasing much more rapidly than the volume of national income (27). Second, industries (such as iron and steel) in which imported inputs are very substantial in relation to domestic value added are assuming a more dominant role in the economy (28). Where imports are embodied in exports, and even more so where they are retained for domestic consumption, import dependence is reinforced by export dependence. These different types of dependence imply different types of problems, such as those of competitive power, geographical complementarity, and diversification of sources, markets, and commodities. In the consumption of imported raw materials, Japan's dependence has markedly increased not only in absolute but in relative terms in recent years. The ratio of the consumption index of imported crude materials divided by the production index of manufacturing industry rose steadily between 1951 and 1956 (31). Also the ratio of the index of consumption of imported raw materials to the index of consumption of total raw materials increased from approximately 92 in 1958 to approximately 109 in 1956 (30).

Consistently during both the interwar and postwar periods, the delivered cost of imports (c.i.f.) has exceeded the proceeds from exports (f.o.b.). Accordingly, in order to pay for needed merchandise Japan has been obliged either to import capital or to provide a net supply of services to others. During the interwar period, the invisible account was largely in surplus, primarily from marine freight income. This contrasts sharply with the large deficit in the postwar transportation account, which has contributed to the consistently unfavourable

(27) For various reasons, the ratio of foreign trade to national income is inadequate as an indicator of the degree of dependence. See H. Hellyer, op. cit. However, it may be useful as a first approximation.
(28) Steel exports in 1957 were valued at $1.730 million, while imports of steelmaking materials (iron ore, coking coal, scrap iron, and pig iron) were valued at $7.790 million, resulting in an unfavorable balance of trade in steel amounting to $5.950 million.
(31) total of postwar invisibles (31). The latter has steadily deteriorated since 1960, producing a deficit of $1.272 million in 1967. The deficit in invisibles has occurred despite massive receipts from U.S. military "special procurement", which are included among the invisible transactions. During the 1960s these receipts annually exceeded one-third of a billion dollars, rising to over half a billion in 1967 (32).

While the invisibles sector of the current account has deteriorated, the structure of Japan's merchandise trade is undergoing dynamic change. Progress can be seen in the fact that the ratio of exports of heavy and chemical goods — about two-thirds of total exports — is approximately the same for Japan as for the leading Western industrial countries (33). However, both the modern and the traditional exports are subject to difficulties. In the latter category (textiles, sundry goods, and light machinery) Japan faces intense cheap-labor competition from the developing countries (34). In the former, Japan's "heavy industry" category includes such items as sewing machines, insulated wire, electric record players, radio receivers, electric fans, dry batteries, electric light bulbs, binoculars, cameras, lenses, watches, and clocks (35). Consequently, the statement that by 1966 two-thirds of Japan's exports to the United States, her leading customer, were in the heavy and chemical industry category is not necessarily as impressive as it might seem. Among these, as among similar items formally classified as products of "light industry", moreover, Japan receives intense competition from less developed countries (36).

(31) Although Japan is the world's leading shipbuilder, the volume of her cargo is increasing faster than the rate of increase in Japanese shipping. In 1967, about two-thirds of all new Japanese ships were sold for export rather than to Japanese shipping companies, many of these being chartered back to Japan by foreign owners.
(32) Direct and indirect benefits to Japan resulting from the Vietnam War are estimated at about $1 billion annually.
(33) In 1959, at their peak, exports of silk provided 40 percent of Japan's export earnings. By 1966, Japan was a net importer of raw silk. In 1967, she became a net exporter of raw silk.
(34) She is also competing with Mainland China, whose exports of cotton cloth approximately equalled those of Japan in 1967.
(36) About one-quarter of Japan's textile exports and about one-half of her total sundry goods exports were sold to the United States in 1966. In the case of iron and steel, about half of Japan's total exports are shipped to the United States. In order to sell steel to the American market, Japan must offer delivered prices at least 70 percent lower than corresponding domestic U.S. prices.
Japan is also subject to discrimination and harassment in terms of commercial policy. In the United States, for example, the steel industry has joined with the textile and other industries in seeking protectionist legislation against her. These campaigns have frequently resulted in the acceptance by Japan of "voluntary" export quotas to forestall further barriers on the American side. Market prospects are also affected by the increase in worldwide excess capacity in iron and steel; by 1967 this overhang roughly equalled Japan's own total national output capacity.

The long-term prospect for ship exports is likewise in doubt. West European countries and also the Soviet Union have made remarkable progress in modernizing and expanding their shipbuilding facilities. They are particularly well equipped to compete with Japan in the construction of specialized ships, such as container ships, liquid methane gas carriers and nuclear-powered ships. By 1968, even in the building of super-tankers, which had formerly been a Japanese monopoly, new contracts were being won chiefly by European shipyards. Even in the past, moreover, while making a solid contribution to the nation's balance of payments, expansion in sales has been achieved at the cost of very low profits to the industry itself. Japan's shipbuilders have been able to offer generous credit terms because of the low-interest funds provided by the Japan Export-Import Bank; prior to 1968 they had been able to borrow as much as 80 percent of total construction costs. Thereafter, however, due to increasing pressure on the bank to provide export finance to other sectors of heavy industry, this proportion will be reduced to below 50 percent. On the whole, with regard to her ability to offer attractive terms of deferred payment, Japan is competitively weak as compared with Western countries.

On the import side, in addition to industrial factors affecting imports as mentioned above, the extraordinary increase in consumer goods purchased from abroad calls for special comment. During the 1960-66, imports of foodstuffs (including beverages and tobacco) into Japan increased more than threefold. Japan's degree of self-sufficiency in foodstuff is now less than 80 percent. Consumer goods other than food are also being imported increasingly.

The current account as a whole was in deficit during five years of the seven-year period 1961-67. Nevertheless, during four years of the same period Japan incurred a net deficit in the long-term capital account in order to finance her sales of heavy industry products (37). For while the advanced countries of North America and Western Europe account for almost half of her total export sales, the developing nations — with the assistance of Japanese long-term capital — are her leading customers for the expensive products of the heavy and chemical industries. For a country endowed with such a scanty supply of capital as Japan, her status as a creditor on long-term capital account is hardly a sign of economic strength. Rather, it reflects a remarkable state of exigency (38). Much of this difficulty could be dissolved if Japan were willing to import more from Southeast Asia, whose accounts with Japan have been conspicuously unbalanced (39). However, government policy in this matter is adversely influenced by the interests of the Liberal Democratic Party, which might forfeit the support of agriculture and small-scale industry if imports from Southeast Asia were officially encouraged.

Thus far we have been speaking of the chief elements of the basic balance (which includes merchandise, services, transfer payments, and long-term capital movements). The sharp fluctuations in Japan's basic balance are partly the result of cyclical fluctuations (including the effects of supply-oriented exports) and partly from the strong adverse secular tendency of the autonomous items of the invisibles account. Characteristically, Japan has depended upon compensating fluctuations in the short-term capital account to fill the gaps in the basic balance; but this in turn is dangerous because short-term capital is itself subject to erratic movements (40).

(37) Some of these export "sales" are the contributions of Japanese partners to joint venture development activities abroad. (The technique of "develop and import" is one means by which Japan promotes capital goods exports while simultaneously diversifying her sources of raw material supply.) Others are arranged in conjunction with economic aid provided by Japan to less developed countries.

(38) Japan even provides long-term credit to the USSR. As a condition for participating in the Siberian development project, the USSR has agreed to lend to the Russians at an annual interest rate of 5.5 percent.

(39) In 1967 Japan's favorable commodity trade balance with the group including Hong Kong, Korea, Taiwan, Thailand and Vietnam amounted to $2.1 billion. Instead of the obvious fact that Japan buys too little from Southeast Asia, the usual explanation of her low level of trade with that region emphasizes that the latter is "too poor" to increase its purchases from Japan.

(40) In particular, Japan is vulnerable as a heavy net short-term borrower in the volatile Yen-dollar market. At the end of 1967 her borrowing amounted to $1,542 million (out of a total Yen-dollar market amounting to approximately $16 billion). At the same time, short-term lending claims on Japan by the United States amounted to $3,954 million, about two-thirds of which was in the form of import advances. Concurrent short-term United States
At the same time, Japan's foreign exchange reserves, amounting to $1,005 million at the end of 1967, were acutely inadequate, being insufficient to pay for only two months' imports (41). The level of reserves had remained fairly constant since 1965, although in the meanwhile the level of trade had roughly doubled. Even the apparent stability in the level of the reserves, however, owed much to the fact that the total included borrowed as well as owned reserves.

The danger of compounding inadequate foreign exchange reserves with a high level of short-term foreign borrowing was demonstrated in the "yen switch" episode of 1966-67. This emphasized that Japan is dependent not only on the availability of credit in United States money markets but also upon an interest rate differential in Japan's favor. The episode occurred when an easy credit policy introduced in Japan following the 1964-66 recession coincided with a restrictive policy in the United States. The fall in the Japanese interest rate led to a switch away from dollar import usance in favor of domestic import trade bills. Consequently, during the eighteen months following July 1965 the combined outflow of both short-term and long-term capital amounted to almost $2 billion. The possibility of creating a similar coincidence following the adoption of more restrictive monetary and fiscal policies in the United States in mid-1968 was a factor forestalling the remission of tight money policies in Japan at that date.

The increasing instability of Japan's overall balance of payments reflects the impact of the factors mentioned above. During the six-year period 1962-67, the overall balance was as follows:

<table>
<thead>
<tr>
<th>JAPAN'S OVERALL BALANCE OF PAYMENTS</th>
<th>millions of dollars</th>
</tr>
</thead>
<tbody>
<tr>
<td>1961</td>
<td>236.4</td>
</tr>
<tr>
<td>1962</td>
<td>-146.7</td>
</tr>
<tr>
<td>1963</td>
<td>155.6</td>
</tr>
<tr>
<td>1964</td>
<td>604.6</td>
</tr>
<tr>
<td>1965</td>
<td>334.5</td>
</tr>
<tr>
<td>1966</td>
<td>92.2</td>
</tr>
<tr>
<td>1967</td>
<td>-397.1</td>
</tr>
</tbody>
</table>


As a countermeasure, the authorities have introduced a program of "Stop-Go" economics, distinctly reminiscent of postwar British policy. A survey of other countermeasures is given below.

5. Countermeasures

Various types of difficulties have been identified in the present stage of Japan's transition. Some arise from the depletion of sources of growth, some are due to structural defects revealed by growth, some are due to Japan's increasing instability and growing dependence on the world economy. The categories of difficulty also of course overlap, as do the countermeasures which have been devised to deal with them.

In the category of depleted growth factors, of prime importance is the attenuation of the labor force. Government has responded with a plan to "liquidate the dual economy," attempting to shift scarce or underemployed factor supplies from traditional industries of lower productivity to modern industries of higher productivity. This approach, in turn, however, creates its own difficulties, for the backward sector cannot be liquidated and at the same time exploited — as it has been in the past — in the interest of the growth of the
leading sector (42). By the same token, liquidation of the backward sector implies raising the capital-output ratio. Since capital remains scarce, future advances in productivity will be more expensive than those of the past. On the international plane, the "catching up" process had yielded another source of easy productivity gains by the import of foreign technology; but after acquiring the standard processes of the West, this species of shifting has become progressively more expensive. As a countermeasure, the government has attempted to encourage the expansion of domestic research and development. But the immobility and compartmentalization of her society, which might have been an advantage at an earlier stage, have become a decided handicap to Japan's future development. In particular, the interchange of ideas and personnel among government, business, and the universities, and job mobility among firms, so common in the West, is not very far advanced in Japan. Even within a particular firm — except for a few of the newer enterprises — upward mobility of young people with creative ideas is very restricted. Moreover, the amount of resources being devoted to technical research in Japan is relatively low. In 1966, 3.7 percent of Japan's national income was devoted to technical research as compared with 3.7 percent in the United States (43). In Japan, moreover, only about one-third of research funds are provided by the government, as compared with two-thirds in the United States. Research, as any other kind of investment in Japan, is expensive because of the capital shortage.

Difficulties within the structural category are complex and deep-seated. These include problems of the balance of payments, excess productive capacity, the dual economy, the debt structure of firms, the system of capital markets, the system of distribution, institutional rigidities, and the accrual of social and economic infrastructure. Countermeasures have been devised by both business and government at many different levels and in various sectors of the economy. Some of these have already been mentioned (44). How-

ever, concentration and centralization are the overriding strategies adopted by business and government respectively.

Concentration is motivated by various business incentives. In the Japanese milieu, especially at the present stage of development, an important objective is to curb "excessive competition" for market shares, which has generated cutthroat pricing, low profit rates and excess productive capacity. As the scale of investment increases (whether or not justified by economies of scale) and the gap between capacity and current demand widens, excessive competition sharpens the instability of firms. When as a countermeasure they finally coordinate their investments plans, this blunts the supply-leading phenomenon as one of the prime ingredients of the growth rate. At the same time, of course, it tends to produce price rigidity and exploitation of consumers.

While concentration reduces the degree of competition among domestic firms, it also provides a means of defense against giant foreign firms whose entry into the home market is anticipated as a result of import liberalization. Defense can be prepared both by means of increases in productive efficiency and by increases in market power; sometimes concentration enhances the former in terms of economies of large scale production or distribution, but more often it merely strengthens the brute bargaining power of firms.

Concentration by means of mergers is often instigated by banks, each of which seeks to enhance the position of its clients, to rescue its shakier loans by delivering a weak client into the hands of a stronger, or to round out an industrial empire with which it is affiliated. Each of these reflects either a cause or an effect of what has been described as "excessive competition among banks". Banks have also played a leading role in reconstituting the surviving elements of what formerly were zaibatsu combines. In their postwar form these reconstituted giants are known as keiretsu, and are distinctly different from their predecessors (45).

(45) In particular, they are no longer subject to the group discipline of their former parent holding companies, the latter having been not merely "demonstrated" but actually abolished during the Occupation. The grip of combine discipline over concentric markets was probably more effective in establishing zaibatsu control than the relative size of the component combines within their respective industries. As exploited by Eleanor Hadley, a relatively small zaibatsu enterprise in a particular market would remain unchallenged by rival zaibatsu firms because in some other market the comparative power of the various zaibatsu might be reversed. The zaibatsu, therefore, for fear of retaliation not necessarily in a given market but in other markets. In the absence of top
With much the same arguments as those presented by business, concentration has also been actively supported by the government. Efficiency, stability, and defense of the home market against foreign firms have been emphasized. Accordingly, the government has fostered horizontal (though not vertical) mergers by offering tax incentives, special long-term loans at low rates of interest, and relief from previously incurred debt. Mergers sponsored by the government have occurred mostly in "key" industries (46). In addition to mergers, economic concentration in Japan has been achieved by means of cartels (47), by the domination of leading firms over their subcontractors, by the acquisition of subsidiaries, and by the formation of combinats (48).

Besides the reasons already given, however, the government favors economic concentration because it conforms with its collateral objective of promoting centralized government control. Strong central control is both historically familiar and institutionally congenial to Japan. Moreover, as seen by the authorities the increasing degree of instability in Japan's present transition sharpens their case for further economic controls. But one of the subtleties of the present holding companies, however, the keiretsu lack the means of implementing in-market retaliation. Consequently, "exclusive competition" now takes place among keiretsu as well as among other firms. Also, in finance, production and distribution, the activities of keiretsu are less exclusively confined within the boundaries of the group than was the case previously. For example, Mitsui and Mitsubishi firms transcended considerably more business across group lines, both with one another and with third parties, than did their peer predecessor firms, both with one another and with third parties, than did their peer predecessor firms. A given amount of especially, they may each depend upon common sources of finance. A given amount of concentration as measured by relative size of keiretsu firms, therefore, implies a different and probably a more degree of market control than is held in the present period.

A notable example of a merger forced through by government threats and inducements was the shipping merger of April 1964, in which 34 shipping companies were reduced to six.

Technically, cartels were legal under the original provisions of the Anti-Monopoly Law, but its amendments are very permissive. Many types are to be found, including "rationalization," "depression," and foreign trade cartels. Some cartels are authorized not by specific law but simply by the recommendation of the Ministry of International Trade and Industry; cartel discipline, moreover, is not enforced by the ministry even upon foreign trade cartels. Cartels, however, are now being reorganized under the Fair Trade Commission, responsible for implementation of the Anti-Monopoly Law, as a result of deregulation which purely the concentration movement.

The combination in a technical combination of physically contiguous plants which look, like a unit and operate as a unit but which are owned by various firms retaining their separate identities.

Recent Difficulties in Japan's Economic Development

The instruments of government control in Japan lie on several levels, overt and invisible. The former exists in the form of statutory law, the latter in the form of administrative interpretations and procedures, otherwise known as "guidance." Much of the influence of the Japanese Government is exercised in the form of administrative guidance and the apparent smoothness with which major economic indicators are pulled into line after having gone off course owes a good deal to this form of control. However, while Japanese are accustomed to responding to the system of invisible pressures and privileges, it is more convenient for the government to invoke them in a business environment of the few rather than an environment of the many. Accordingly, the government fosters economic concentration in various forms. Besides the mergers already discussed, these include powerful trade associations, which, for example, in their own name can force their members to comply with informally communicated government requests that have no explicit legal basis.

In responding to its increasing obligations under the import liberalization program, the Japanese Government has prepared countermeasures of two types. First are those such as rationalization and modernization of plants, designed to cope with the new competition of foreigners in the home market. Second are measures designed to replace other means the restrictions which have been nominally relinquished in the name of the liberalization program. It need not be assumed that the latter are entirely disingenuous. As for implied by its qualities of dependence and instability, it can be argued that without some system of controls the Japanese economy would long ago have been shipwrecked on its voyage into the realm of import liberalization. The Japanese authorities understand this much better.

An outsider may have difficulty in deciding whether or not a given situation is government-controlled. For example, there is no government price control over ammonium sulphate, but the price is established in consultations between the governments and the ammonium sulphate producers' association. Also, there is no government subsidy of ammonium sulphate, but the producers who sell at a loss to domestic farmers are able to recoup their losses by some means or other approved by the government.
than outsiders. The inadequate size of the foreign exchange reserves, for example, requires that the economy be managed on a very short term basis. This in turn, however, does play directly into the hands of those who seek to widen the scope of administrative guidance. The important role of guidance within the Japanese milieu emphasizes the difference between private enterprise as understood in the United States and private enterprise as understood in Japan. By the same token, it adds to the rationale for excluding foreign firms from Japan. For since foreigners may not understand or choose to recognize the signals by which the game is played, the presence of too many foreigners in Japan might subvert the system (59). At a purely bureaucratic level, it is also clear that agencies, principally MITI, which have been forced to relinquish visible controls in accordance with the liberalization program have been very zealous in exercising their remaining prerogatives as well as in relaxing the visible controls with invisible ones.

Concentration and centralization are inward-looking; but as Japan’s dependence on the world economy increases, more outward-looking policies are required. Besides the general effort to promote exports, special efforts have been made to reduce Japan’s disproportionate dependence on the United States. In particular, diversification of sources and markets has greatly increased the prospect of expanded trade with communist areas. The promulgation by Japan in 1967 of a “Pacific Basin” concept, calling for increased economic cooperation among the United States, Canada, Australia, New Zealand, and Japan might also be noted, but its contribution is likely to consist of little more than discussion in the foreseeable future.

Leon Hollerman

Claremont

(50) The Japanese also fear that a foreign firm which has been allowed to enter for a given activity may expand into other activities, as from production to distribution, or from one industry to another. Incidentally, in resisting further measures of liberalization, the Japanese are sometimes supported by foreign firms which have already entered the economy and thus acquired a common interest with the Japanese in excluding all other outsiders.