Notes for Topic 6: The Japanese "Economic Miracle"

1 Amateur History

1. In the decades before World War II, Japanese society transitioned from a poor (but relatively equal) society to a more open , wealthy, and industrialized economy. One notable event in this process was the 1905 Russia-Japanese War where Japan curb-stomped Russia and emerged as a global power.

2. As Japan modernized, it needed more natural resources: oil, rubber, etc. Japan, however, is famously resource poor and had to obtain these resources from other sources. This helps explain why Japan became expansionary.

3. Japan's involvement in World War 2 began in the 1930s with its invasion of China. In 1941, it attacked Pearl Harbor, leading to the U.S. entry into the War.

4. Japan suffered complete defeat in the War. It lost all uts overseas territories. It suffered massive loss of life and destruction of physical capital. It was occupied by the U.S. military and its new constitution still forbids it from having a significant military.

5. The war had profound impacts on the Japanese economy. It became much poorer but more equal (the poor became poorer less rapidly than the rich became poor).

6. After the war, Japan's economy beat all expectations by growing exceptionally rapidly through the 1980. This has come to be known as the Japanese 'economic miracle."

Core Concepts:

1. Convergence. Do rich countries grow faster than poor countries? There are two ways to answer this.

First, we could simply compare rich versus poor countries. If we do, there is no clear tendency for poor countries to catch up to wealthy countries. This is somewhat misleading, however. Often, the factors that caused a country to originally become poor (*e.g.* low investment, poor institutions, civil war, etc.) also keep them from catching up.

Another way to answer this would be to do an experiment. What if we could construct two economies that are identical in every way except that one is initially poorer than the other?

Such an experiment cannot be run in real life, but we can use statistical techniques (well beyond the scope of this course) to try to answer it. When we do, we find that poorer countries do tend to catch up. We call this result *conditional convergence*.

These results mean that we should not be surprised to see poor economies remain poor if they have not removed the obstacles that initially led to poor economic performance. If, however, a poor economy successfully makes changes to remove these obstacles, a period of rapid growth may follow. Japan has been an example on two occasions. First, in the late nineteenth century, the economy grew rapidly after Japan opened up to the rest of the. Japan, along with Germany, then experienced, rapid growth after their military defeats that surprised contemporary observers. A more recent example is China which, following economic liberalization in the early 1980s, has experienced rapid growth since.

Importantly, the rapid growth from these examples does not mean that they generally surpass the world's richest economies. Instead, as they close the gap, their growth slows
2. Guns vs. Butter. Economies face a tradeoff between the type of goods and services they produce. Guns vs butter is a term that describes whether an economy should produce goods for consumption (butter, which is delicious) or for military expenditures (guns). More broadly, we can think of these tradeoffs as between production that provides immediate benefits for households (beer) or production that brings long-term benefits (capital goods).

In a market economy, there is no guarantee that the economy will produce as many military goods as policy makers would like. War therefore often requires that the government intervene to move the economy towards a more planned economy which, as we have seen with the Soviet Union, generally perform poorly. For communistic economies, this is easier than for capitalistic economies that generally have less government involvement. As we saw with the U.S. experience in World War Two, economic management is a major aspect of war planning.

3. Savings vs Investment. This is an example where the meaning of terms differs by context. In common English, we might say that a household that buys stock is investing. In economics, however, this is saving. Savings refers to households deferring consumption today for future consumption. They can do so using all sorts of instruments such as savings accounts, stocks, etc.

Investment refers to firms buying physical capital. This might entail business equipment, an expansion, a building, software, etc.

Although they are not the same, there is an important connection between the two. Household saving can be used to finance business investment. As a result, countries with higher savings rates tend to have more capital and thus be wealthier than countries with lower savings rates.

The two are closely related and higher investment helps explain cross-country income gaps.

2 Big Questions

. 1. Prior to World War 2, Japan was one of the most unequal economies in the world. During the war, it sustained both a catastrophic decline in living standards and to inequality. Why?

Prior to World war 2, Japan had experienced a rapid period of modernization that left it as one the wealthiest, but most unequal, advanced economic sin the world.

> Japan was once one of the most unequal countries on earth. In 1938, the country's "1 percent" received 19.9 percent of all reported income before taxes and transfers. Within the next seven years, their share dropped by two-thirds, all the way down to 6.4 percent. More than half of this loss was incurred by the richest tenth of the top bracket: their income share collapsed from 9.2 percent to 1.9 percent in the same period, a decline by almost four-fifths.

Scheidel, Chapter 4, page 115

One obvious candidate for the changes to Japan's economy during the war is the destruction of physical capital, mostly through bombing. Furthermore, Japan suffered massive losses to its workforce through its military defeat. because physical capital is concentrated in the wealthy, its destruction not only reduces overall economic performance, but also is leveling Importantly, this is another case where greater equality does not mean that the poor are better off. Scheidel documents this destruction of capital, but also notes that its impact is overstated.

> By September 1945, a quarter of the country's physical capital stock had been wiped out. Japan lost 80 percent of its merchant ships, 25 percent of its buildings, 21 percent of its household furnishings and personal effects, 34 percent of factory equipment, and 24 percent of its finished products. the number of factories in operation and the size of the workforce they employed nearly halved during the final year of the war....

> Yet despite the losses this caused to the owners of real estate and investors, the overall effect must not be overestimated. Thanks to the aggressive wartime expansion of heavy industry, the volume of production equipment that survived in 1945 exceeded what was available in 1937.

-Scheidel, Chapter 4, page 123

Scheidel argues that while the destruction of physical capital was important, the real reasons for Japan's economic transformation was structural. He argues that the biggest factor was that the Japanese government assumed a much larger role in the Japanese economy which reduced its effectiveness.

> The first [regulation] of these three mechanisms was the most important. State intervention gradually created a planned economy that only created a facade of free market capitalism. What started out as emergency measures expanded and became institutionalized over time. The command economy of Manchuria, which had been under Japanese occupation since 1932, provided a model. In spring 1938, the National General Mobilization Law gave the government wide-ranging powers to press the Japanese economy into service for the war effort: the ability to hire and fire, determine working conditions, produce distribute, move and price goods, and settle labor disputes. ... The top marginal tax rate doubled between 1935 and 1943.

-Scheidel, Chapter 4, page 119

Scheidel's argument is that Japan's economic fate was similar to that of the early Soviet Union in that a relatively efficient capitalist economy was replaced by an ineffective command economy. The method was different, in the Soviet Union, revolutionaries overthrew the government with the explicit aim of imposing a new ecoomic system. in Japan, the existing government transformed the economy based on military needs. Schiedel writes:

> More generally, war pressures gave rise to the novel idea that a firm should not be the sole of stockholders, but rather a communal organization that involved each of its members.

-Scheidel, Chapter 4, page 120

2. Unlike other advanced economies, like the United States, Japan's reduction in inequality was quick, occurring almost exclusively during the war. After its defeat, Japan was occupied by the U.S. What were the economic implications of the occupation?

The primary goal of the U.S. occupation as to prevent a revival of Japanese militarism. The occupying authorities thus tried to reduce the power of the business interests that dominated pre-war Japan. This also had the effect of maintaining a relatively equal economy. The new Japanese constitution also forbade Japan from maintaining a significant military. This further reduced the power of the wealthy who had profited from military contracts.

> Both corporations and landlords became the targets of aggressive restructuring. The three main goals of the U.S. occupation government were the dissolution of the *zaibatsu*, democratization of labor, and land reform, measures that were to be implemented in conjunction with punitively progressive taxation. The ultimate objective was to eliminate not only the material capacity for war but also the perceived source of imperialist aggression. Economic reforms formed a broader range of fundamental democratizing changes designed to reshape Japanese institutions: a new constitution, female suffrage, and a thorough revision of the court and police system, to name just a few. All of this was implemented as a direct consequence of the war, which had resulted in foreign occupation

-Scheidel, Chapter 4, page 124

Notice how many of these changes fall under the banner of "institutions." Expanded suffrage increased democracy. Better courts improved the rule of law. Collectively, these changes may be thought of as restoring elements of Japan's pre-war economy. The occupying authorities were motivated, however, by the New Deal. The reforms were thus done in a way that, as we will see, both improved average economic performance without a reversion to pre-war levels of inequality.

> Interventions in the economy explicitly pursued leveling as a means to achieve the desired outcomes. The "Basic Directive" for the American occupation authorities entitles "Democratization of Japanese Economic Institutions" urged the promotion of a "wide range of income and of the ownership of the means of production and trade." Aiming for the creation of a social welfare state, occupation policy goals were closely associated with those of the New Deal... The occupiers wielded the weapon of taxation with a heavy hand. between 1946 and 1951, a massive and

> progressive property tax was levied on the net value of assets, with a low exemption level and a top marginal rate of 90 percent. Applied to assets rather than income or just estates, it was overtly confiscatory in nature.

-Scheidel, Chapter 4, page 124

3. Post-war, Japan's economy achieved what has been called an "economic miracle," where its economy grew remarkably quickly and, by the 1980s, was among the wealthiest in the world. This was nit expected. After the war, many economists expected Japan to remain poor for many decades. what caused Japan's rebound?

We begin with some background:

> The performance of the Japanese economy since the Meiji restoration in 1868 has been quite extraordinary. Japan emerged from the intense isolation imposed by the Tokugawa as an economic backwater, lagging far behind the west. But by the end of the 20th century, her economy had become the second most powerful in the world. And this was accomplished in spite of the vast devastation that she suffered as a consequence of her defeat in World War II. Although the sustained growth of the Japanese economy from 1868 to 1989 was remarkable by itself, the 18 year period between 1955 and 1973 was especially noteworthy. For over the latter span the average annual growth rate of the Japanese economy measured in terms of real GNP rose to almost 10%. The singular nature of this achievement is captured in the phrase "Japanese economic miracle which has come to be used to describe the phenomenon.

-Katzner

Part of Japan's recovery is due to convergence. All other things equal, a poorer country will grow faster than a rich country. The poor country can accumulate physical capital faster and "catch up." This is especially relevant for an economy, like Japan, that suffered from capital destruction during the war. There may be other low-hanging fruit as well. Eliminating the command economy imposed during the war also improved performance. these options were not available to a rich economy like the United States. Another factor was Japan's high savings rate which allowed it to rapidly recover its capital losses.

Poor countries do not, however, generally grow faster than wealthier ones This is because "all other things" are not usually equal. if an economy is poor because of civil war or weak

institutions, it will not grow rapidly until these factors improve. In Japan's case, however, institutions improved, as did education. It also helped that Japan did not have to outlay for a significant military.

There are other factors, as well. Japan pursued a strategy known as *export-based growth*. This has proven to be the most effective growth strategy for transforming an economy from poor to rich. Other examples include Taiwan, Korea, and more recently, China. It does, however, come with costs. While growth is strong, these benefits do not fully pass through to households. Japan had a unique approach to export-based growth.

> Japan is the purest example of what has become known as a producer economic state, and many of its economic practices are now familiar. For nearly 40 years, the country subordinated other goals in favor of catching up with and perhaps surpassing the U.S. economy. The revisionist critics correctly emphasized the role played by Japan's government in working toward that goal, but they neglected the other two pillars of Japanese success: large companies and a well-educated workforce. Those three pillars cooperated on an unusually focused developmental strategy that generated impressive economic efficiencies.
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> A key element of Japanese success was the keiretsu. By banding into keiretsu—huge business groups that link industrialists, banks, and trading companies through reciprocal ownership of stock and long-standing exclusive relationships—individual companies gained financial strength and connections that allowed them to undercut foreign and domestic rivals. Their mission was to gain market share rather than accumulate short-term profits, and they aggressively entered high-growth sectors with long-term potential. The concerns of consumers and outside stockholders, who had few other outlets for their earnings besides low-interest savings accounts, were secondary.
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> Although the keiretsu themselves were stable, they created a business environment of extreme competition, at least in the sectors that targeted international markets. Japanese companies (kaisha) went to great lengths to keep up with one another, copying new-product designs as well as innovative production techniques. If they fell behind, they suffered a loss of reputation, or face.

-Crawford

By the 1980s, many American observers were convinced that the Japanse economic model was more efficient than others and that Japan would soon become the world's wealthiest economy. This led many American firms to adopt some U.S. customs. it also led to xenophobia. A closer look, however, suggests that the picture was more complicated. Japan was pursuing economic growth at the expense of many other considerations. It was actually less efficient than most other advanced economies. Inequality began to rise again, although it remains lower than in the Unuted States.

> In practical terms, such competition meant that new ideas and technologies could be absorbed throughout the economy with extraordinary speed. Under the envious eyes of Western observers, Japanese managers seemed to easily integrate robots, computer chips, and "fuzzy logic" software into their manufacturing plants and products. And Japan's competitive spirit also spawned some of the most widely imitated practices in industrial management: total quality control, lean production, and cross-functional product development.
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> Manning the kaisha were the elite salarymen: loyal, lifetime employees willing to work extremely long hours. Hired directly out of the country's prestigious universities, they were cloistered in company dormitories and drilled to learn rigid rules of behavior, such as the precisely choreographed submissive posture to take before certain clients and how low to bow to various superiors. The rules constituted an entire coded language incomprehensible to outsiders. Even very young Japanese students were part of the regimen, as they submitted to a grueling examination system that prepared them to enter corporate life with dependable analytical skills and a proper attention to rules.
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> The Japanese government, meanwhile, acted as a business adjunct and referee, steering keiretsu into promising sectors by providing tax breaks, cheap credit, and "administrative guidance." A variety of other policies assisted and protected companies, including trade barriers and an exchange rate that discouraged imports and promoted exports. For their part, Japanese consumers accepted high prices and scarce credit. While the kaisha grew in leaps and bounds, their employees and the rest of society made do with relatively low living standards.

-Crawford

By the 1990s, Japan's performance stagnated, beginning a period known as the 'lost decades." We will not go into the reasons for this change in detail, except to mention that it is related

to difficulties transitioning from export-based growth to a consumption based economy. Demographics, especially population decline, have also played a part.