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The Japanese Economy in Transition

The Move to Greater Profit Orientation

Economists often use the word “transition” to describe countries whose economies are moving from planned, socialist methods to more capitalistic, market-driven ones. Japan’s economy also is making a transition, perhaps not as radical as that of the former communist states but, to the Japanese, almost as dramatic.

To be sure, Japan has had a capitalist, market-oriented economy at least since the period following the Meiji Restoration of the 1860s. The reference to Japan’s present course as a transition in the same sense as the former communist regimes may be stretching the definition of the word. Yet the world’s second-largest economy is acquiring a more profit-oriented thrust with a new focus on such capitalistic norms as returns on assets and the bottom line. Describing it in terms of transition helps to dramatize the point that in embarking on such a major transformation, Japan—like Eastern Europe and Russia—is hobbled by institutions, laws, regulations, habits, and a pervasive psychology, all of which are more appropriate to the old ways than to the present trajectory of economic life.

Several fundamental difficulties hamstring the Japanese economy today. Long-term growth has slowed to a rate that is typical of other advanced countries—around 2 percent annually. Overall productivity is relatively low and is lagging seriously in many high technology industries and services. Business has overinvested. Given the combination of overinvestment and low productivity, rates of return are well below those of the United States and major European countries. Finally, the financial system is saddled with the bad loans and the wrecked balance sheets generated by the collapse of the asset price bubble at the start of the 1990s.

All but the last of these problems existed years before the bubble burst. Sooner or later, Japan would have had to confront the economic complications arising from slow growth, skimpy productivity gains, and too much capital tied up in low-return investments. The financial collapse brought about by falling asset prices forced attention on all problems at once—hence, an economy in transition.

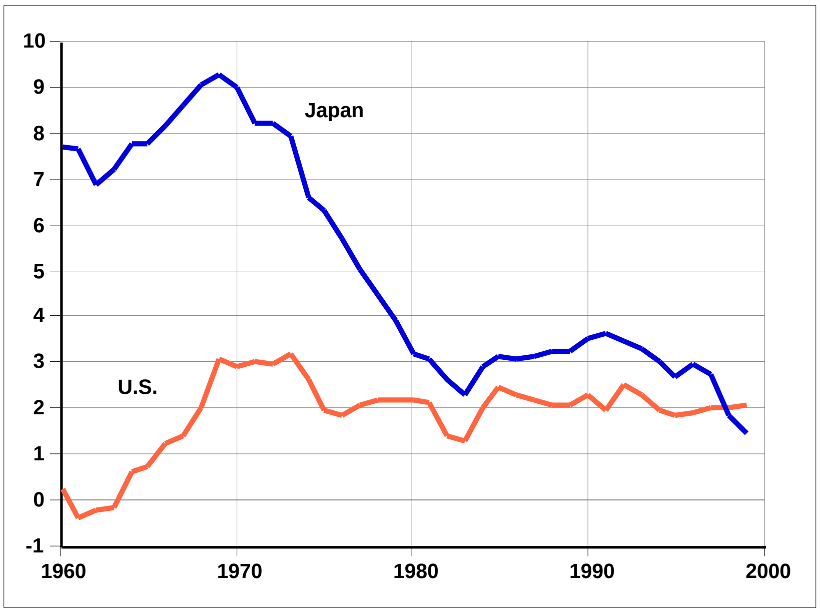
This chapter focuses on two key issues. First, what is driving the changes now underway in Japan? Second, why did it take so long for Tokyo and corporate Japan to recognize the nature of the problems hobbling the economy and to begin dealing with them?

Slowing Growth

Rich nations always grow at a slower pace than high-flying, poorer countries. All fast-expanding countries are poor, although not all poor countries experience rapid economic growth. Growth depends first and foremost on the productive investment of capital in physical and human resources. As investment proceeds and the capital intensity of production and technology catch up with that of the more advanced economies, the rate of expansion tends to decelerate.

The average annual ten-year growth of gross domestic product in twenty one countries with GDP per capita levels over $10,000 (in 1985 prices) was 1.8 percent.[1] Although income and capital do not necessarily predetermine destiny, Japan has followed the path of other rich countries. In fact, since the “miracle” expansion of the 1950s and 1960s, Japan’s march toward the 2 percent level has been relentless, broken only by a spurt during the asset-bubble experience of the late 1980s (see figure 1.1). Most econometric studies conclude that given the growth of the labor force, the projected rate of profitable investment, and the expected increases in productivity, growth will settle sooner or later in the range of 2 percent a year, plus or minus half a percentage point.

Figure 1.1: Average Annual Growth Rate of Real GDP Per Capita, Japan and United States, Over Preceding Ten Years, 1960-99, Percent



Source: Japan: Statistics Bureau, Management and Coordination Agency; United States: Department of Commerce.

To many Japanese business executives and government leaders, not to mention ordinary people, the slowdown from the go-go years of the 1950s and 1960s is a disappointment. However, for a rich country, 2 percent per capita growth is a miracle in its own right. It leads to a doubling of real incomes every thirty five years. For one of the world's richest countries to continue improving the economic welfare of its citizens at such a pace is almost without precedent. It is very much a twentieth-century phenomenon, and it certainly is not automatic. Some relatively rich countries like Brazil and Argentina lost their big-league status in the early part of the last century when their policies and business practices failed to sustain their economic promise. Current initiatives will determine whether Japan can make stable economic gains a twenty first-century experience.

Capital Stock Too High, Returns Too Low

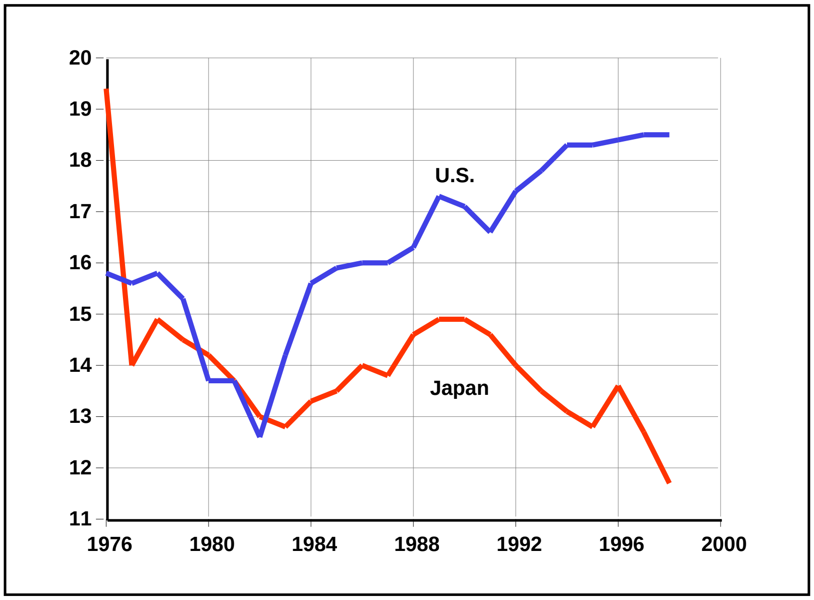
As mentioned, investment is the source of economic growth. The question of why some countries are able to marshal the savings of individuals and businesses and direct them to productive uses still is studied intensely. Some research indicates that education, income equality, price stability, and government competence are preconditions for high investment rates and subsequent economic development.[2] Japan has been a standout on all these requirements.

What remains to be explained is why Japanese companies continued to invest at prodigious rates after returns fell well below the levels achieved in other advanced countries. Even after Japan's ratio of capital to GDP topped that of the United States in the 1970s, capital intensity continued to increase. According to one survey, by the mid-1980s, before Japan's bubble-induced investment binge, the ratio of nonresidential capital stock to economic output was some 40 percent greater than the U.S. figure.[3]

As capital accumulated, returns fell. First, the increased use of capital relative to such other inputs as labor led to decreasing returns. Not surprisingly, businesses slid down their yield curves. However, the second reason behind the reduced profitability of capital was low productivity in the way it was used. Detailed examinations of specific industries and production processes by the McKinsey Global Institute, the research arm of management consultant McKinsey & Co., Inc., found that inefficiency, rather than diminishing returns, explained most of Japan's pattern of declining returns.[4]

According to the Paris-based Organization for Cooperation and Development, and consistent with other studies, returns in Japan fell sharply from the high-growth period and dropped below U.S. levels in the 1980s (see figure 1.2). Since 1982, the gap between the two countries has increased almost every year.

Figure 1.2: Return on Business Capital in Japan and the United States, 1970-98



Source: OECD *Outlook*, June 1966, A80-81.
Note: The figures for 1976 are the average for the years 1970-76. The return to business capital is defined as the ratio of the gross operating surplus of enterprises to nonresidential gross fixed capital valued at replacement cost. Gross operating surplus is the difference between value-added calculated at factor cost and labor income.

A low rate of return on capital is symptomatic of insufficient attention to profitability. Corporate Japan gave making money a low priority for a number of reasons, many of which now are changing. Regulation of the nonfinancial and financial sectors alike blunted the focus on the bottom line. Many firms in the vast nontradable goods part of the economy operated under the consensus-producing aegis of industry associations or under government rules and guidance. These companies were assured that competitors would not introduce new products or lower prices without the consent of most members of the particular industry. Government-condoned collusion and cartels that controlled prices and allocated market shares reinforced this approach to doing business.

An explicit Ministry of Finance commitment to the so-called convoy system assured that no bank would fail and that all banks would make at least some money. In the rare instances of insolvency, MOF engineered a takeover by a healthier bank or organized loans from the government and private financial institutions to assist the ailing bank. For example, in July 1991 when loans to a bankrupt shipping company crippled Toho Sogo Bank, Ltd. it was taken over by Iyo Bank, Ltd. in an "assisted merger," with funds provided by the Deposit Insurance Corp., the Bank of Japan and the Second Association of Regional Banks.[5] The no-failure guarantee for banks extended to depositors and, by implication, to creditors and major borrowers. The reasoning was that if a bank could not fail, neither could a major borrower be allowed to go under because that would threaten the solvency of the lender.

In addition to regulating interest rates and the products offered by banks, Tokyo limited the entry of new competitors into the industry and protected banks from the pressures of a more open capital market by imposing strict limits on how corporations raised funds. Banks, therefore, were at the center of finance. Japanese companies typically had much higher debt/equity ratios than would be comfortable for an American company, bank, or shareholder. For the past 25 years in the United States, the ratio of debt to the market value of equity has tended to be just below 1.0. In the 1970s, the ratio was 3.5 in Japan, falling gradually to around 1.5 as capital markets were deregulated and as the stock market boomed in the late 1980s. With the breaking of the bubble, however, the debt/equity ratio jumped back to 2.0.[6]

Japan's high levels of debt have been explained in part by the so-called main bank system, under which one bank has a long-term, close relationship with a company. Such ties presumably give the bank an inside view of company activities as well as confer on the banks the responsibility for guaranteeing the firm's financial dealings with others. However, a downturn in business can leave an overleveraged firm with an insufficient cash flow to cover interest and debt repayment obligations.

In the past, the main bank was expected to arrange a salvage operation, much as the MOF rescued troubled banks. In fact, this system seemed to work for blue-chip firms, but small companies were not so well protected by their main bank relationships.[7] Therefore, because highly leveraged firms were vulnerable to slower growth, the central position of banks in corporate finance has been associated with elevated rates of business failure. In the 1970s and 1980s, the ratio of liabilities to GDP of failed Japanese companies was about twice the American number. As the Japanese economy has weakened during the 1990s, liabilities as a share of GDP have been four to five times greater than the U.S. rate.

Shifting Perceptions and Policies

Not until well into the 1990s did the reality of protracted slower growth begin to permeate the Japanese psychology. Although GDP gains had begun to drop off in the early 1970s, it took until the end of that decade for the Economic Planning Agency to recognize the slowdown in its official projections. Authorities could point to other plausible causes, including the two oil shocks of the 1970s and the costs of reconfiguring much of Japanese industry to accommodate higher petroleum prices, for what they persisted in believing was a temporary phenomenon. In the 1980s, slow growth was linked to a strong yen or to other external causes. The boom of the late 1980s was not seen as abnormal but rather as a return to the golden times of the past. Similarly, it has taken the better part of the 1990s for business and government plans to incorporate the idea that slower growth is here to stay.

Another shock to the Japanese psyche was the decline in the government's willingness and ability to prop up the banking system. This shift in policy has been quite explicit: MOF has announced that it will not feel compelled to come to the rescue of small banks or to bail out large ones after April 2001. In fact, though, one major bank already has gone under and two others have been taken over by the government. Thus, while Tokyo's guarantee that the financial system will remain whole may not yet be dead, in both rhetoric and reality, this promise is dying.

Today's altered reality for banks is illustrated by the fact that no bank failed from 1950 to 1992. In late 1993, a small *shinkin* (credit cooperative) became insolvent. In 1994, crippling bad loans forced three more *shinkin* to shut their doors. The following year, a "real" bank, Hyogo Bank, Ltd., suspended operations and subsequently was liquidated. By the end of 1999, 11 banks and eight *shinkin* had closed or had been taken over by the government for disposal or liquidation.[8]

The Big Bang also is changing the banking industry. This deregulatory effort, which promises to make Japan's financial markets "free, fair and global" by the end of FY 2001 is liberalizing the introduction of new products, freeing the pricing of financial products and services, and eliminating the walls that separate banks, securities brokers, and insurers.

Capitalizing on the deregulation process, foreign firms are moving into the Tokyo market, bringing with them experience and competitive instincts developed in New York, London, Hong Kong and other markets that liberalized a decade or more earlier. In 1980, for example, only two foreign securities companies operated in Japan. In a 1984 interview, the head of Merrill Lynch & Co., Inc.'s Tokyo office noted that his company sold hundreds of products in New York but only two in Japan—stocks and bonds. By 1985, 12 more foreign brokers had opened securities offices; in 1995, at least 50 such companies were in business. Further liberalization in 1999 simplified entry by requiring only registration instead of MOF's laborious approval process. This incursion can be expected to continue.

Foreign banks, too, have increased in both number and in terms of market share. In the mid-1980s, 74 foreign banks operated in Tokyo, but they controlled just 3 percent of total banking assets. By 1998, offshore banks numbered 91 and held 8 percent of all banking assets.

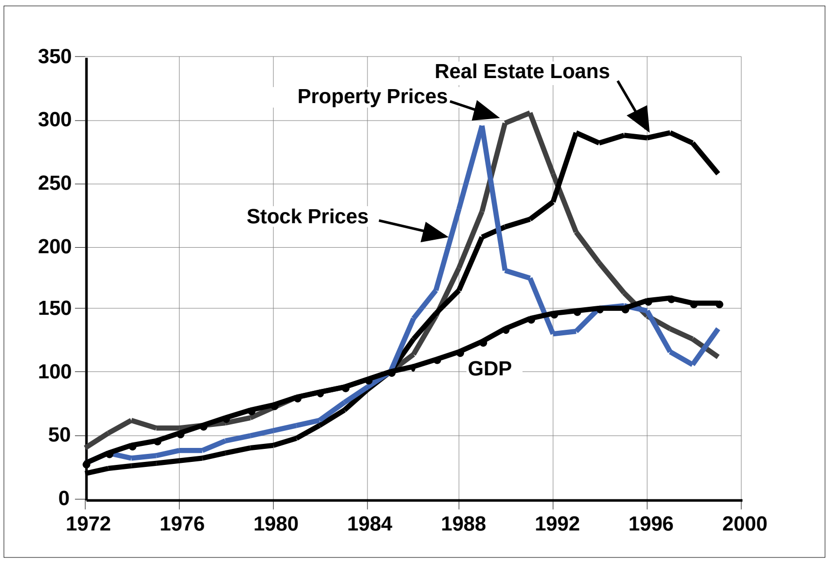
The simultaneous deregulation and globalization of financial markets, combined with fading bank guarantees, is forcing corporate Japan to pay new attention to profitability and the return on invested capital. As part of this process, both bankruptcies and mergers and acquisitions reached new highs in 1998.

Although the government expanded its credit-guarantee program for small businesses in 1999 in an attempt to curb bankruptcies among these companies, the liabilities of failed firms continued to climb, indicating that larger operations were facing insolvency. A key feature of the new M&A situation is that foreign acquisitions of Japanese companies broke all records in 1999. However, despite the unprecedented numbers of takeovers by domestic and foreign companies alike, M&A activity in Japan is still only a fraction of what occurs in either the United States or Great Britain.

Why Did Japan Take So Long to Respond?

Slow growth, overinvestment, low returns and lagging productivity have been features of the Japanese economy for decades. Over that time, the problems have gotten worse, not better. Bank lending based on asset values continued well after stock market and property prices had begun to fall. (See figure 1.3.) The bubble-induced bad-loan situation existed for at least six years before the government began to consider it a threat to the stability of Japan's financial system. It took even longer for banks to confront their problems. Action on other economic issues looming on the horizon has been put off indefinitely, resulting in underfunded private and public pensions, public corporations with excessive liabilities, and as-yet-undisclosed financial weaknesses in manufacturing and services companies.

Figure 1.3: Real Estate Loans and Asset Prices in Japan, 1972-2000 (1985=100)



Source: Bank of Japan and Japan Real Estate Institute
Note: Real estate loans comprise loans to real estate companies, construction firms and nonbank financial companies. Property prices are the average for Japan's six largest urban areas.

Despite what seems at times to be an unwillingness to do anything, policymakers in Tokyo have not been sitting on their hands. The Big Bang, orchestrated in 1996 by then-Prime Minister Ryutaro Hashimoto, was designed to address many of the problems just mentioned. The public recapitalization of major banks in 1999 and the year before, along with stricter official auditing and tighter oversight, was an attempt to clean up the bad loans and the shady practices of earlier times. The massive fiscal deficits that the government began running up in 1991 were intended to boost the economy and get it moving on its own so that the transfusions eventually could be discontinued. All these initiatives have been welcome, but some experts have characterized them as too little, too late.

A look at bank loans for real estate purposes provides an example of how slowly banks and government agencies dealt with a situation that was bad in 1992 and worsened in subsequent years before any actions other than cover-ups were undertaken. Property-related loans in recent years have represented about one-quarter of all bank lending in Japan. Since the value of property typically is the basis for borrowers' collateral, bank lending rose rapidly along with the run-up in real estate prices during the latter part of the 1980s. When the property market began to collapse in 1991, however, banks increased their lending in order to cover borrowers' missed interest and principal repayments.

The book value of real estate loans plateaued in 1993 and did not begin to fall until 1998. For several years, banks reserved against the mounting volume of their obviously bad loans, but they did not take them off their books or renegotiate the terms. Finally, in 1998, as the process of renegotiation, securitization and selling off bad loans to a government collection organization began in earnest, the outstanding book value of real estate-related loans started to drop. However, while property prices in Japan's six largest metropolitan areas are off 60 percent from their peak, lending is down only 9.5 percent (AJA: get latest figures).

Explanations for Slow Response

Japan is a rich country with institutions generally befitting that status. Nonetheless, certain of its government-business relationships, legal structures, habits, and rules of thumb are holdovers from an earlier period. These vestigial institutions, practices, and processes—which resemble those of certain other Asian countries today, especially South Korea—contributed to Japan's current problems and to the delay in recognizing the scale of the economy's troubles and in developing policies to contain the fallout. Given a good deal of overlap, these impediments to action on the policy front can be grouped into two categories: as coming either from the government or from the business community. However, one factor had a pervasive effect—the persistent Japanese belief that a return to rapid growth was just around the corner.

When the bubble burst at the start of the 1990s, the natural reaction was to wait out the decline. Policymakers made their "crossed-fingers" stance almost official, hoping for a pickup in the economy that would solve all the problems without anyone having to do anything. They maintained that do-nothing approach for the better part of five years. Finally, both corporate executives and government leaders began to understand that Japan's mature economy was on a permanently slower growth trajectory and that even if a revival occurred, it would not solve banks' bad-loan problems. This lag in recognizing the true nature of the situation was compounded by other features of the government and the business environment.

Banking Guarantees

MOF's pledge that no bank would be allowed to fail was perhaps the main cause of the overinvestment and the low returns to capital that characterize Japan's economy. It also contributed greatly to the delay in recognizing the scale of the troubles coming from the collapse of the asset-price bubble of the late 1980s.

Much of the government's intervention in the economy in the early decades of the postwar era was in credit markets in an attempt to channel household savings to industry for investment purposes. A regulated, stable banking system was considered necessary to give people confidence that their money would be safe in the hands of bankers. The protection of banks from failure and the provision of guarantees to depositors were integral to Tokyo's strategy for mobilizing savings. In short, a controlled, nonmarket banking system supported high rates of investment, which, in turn, generated the miracle of sustained, rapid growth.

Unfortunately, this method of mobilizing savings and promoting investment also created the conditions that led to the eventual financial breakdown. Even without a collapsing asset market, many banks and other types of companies would have failed sooner or later because of overinvestment and low returns. The side effects of a failure-proof banking system turned routine economic shocks into crises.

As nonperforming loans to real estate and construction interests piled up in the early 1990s and as it became evident that other companies were unable to generate adequate profits with which to repay their loans, the prevailing expectation in financial circles continued to be that the government would work out some kind of solution. Indeed, such confidence was supported by concrete evidence, as MOF found saviors for failing banks and did its utmost to shield even the weakest institutions from full exposure to the consequences of their conditions. The fact that several executives from Nippon Credit Bank, Ltd. and the Long-Term Credit Bank, Ltd. of Japan later faced criminal prosecution for the illegal window-dressing of their books and other acts to cover up the true condition of their banks—apparently with the collusion and encouragement of Finance officials—suggests that the ministry found it difficult to abandon its successful postwar policies.

By the late 1990s, however, the credibility of Tokyo's guarantee was evaporating quickly. Indications were spreading that the government no longer could be counted on to save insolvent lenders, especially with the failures of three giants—Hokkaido Takushoku Bank, Ltd., LTCB and NCB—which had occurred despite the best attempts of the government. Nevertheless, old practices and habits persisted long after Tokyo had lost its ability to preserve or resurrect zombie financial institutions.

Many Japanese officials now say that it was the back-to-back collapses in late 1997 of Hokkaido Takushoku Bank and Yamaichi Securities Co., Ltd. that shocked the political leadership into the realization that the crisis engulfing the financial sector could not be solved by the traditional means of waiting, administrative guidance, and discrete, behind-the-scenes tactics. A more direct policy response was required—one that involved a government takeover of some portion of corporate Japan's unpayable debt and that accepted the government bureaucracy's inability to engineer solutions in an increasingly deregulated and complex financial system.

Protection of LDP Clients

The governing Liberal Democratic Party owes a good deal of its electoral success to the support of and by specific industries. Accordingly, policies that might harm these constituents have not been well received. Construction companies, for example, are an important source of political contributions, even though the property-based investments made by contractors have left many of them close to insolvency. That the LDP strongly supports the industry is indicated by the fact that Japan spent 10 percent of GDP on public works projects and related land acquisitions in 1996; the comparable figure for the United States and European countries was just over 2 percent.[9] Were banks to get serious about cleaning up their bad loans and cutting lending to unprofitable companies, the construction industry would be at the top of the list. The LDP, however, has been extremely reluctant to promote a strict assessment by banks of business profitability that would have the effect of undermining the construction industry.

An even more telling example of the LDP's reluctance to allow weak firms to fail is the ¥30 trillion ($166.7 billion at ¥120=$1.00) that the government contributed in 1998 to a credit-guarantee program for small companies. Total business failures had climbed to 16,500 in 1997 and were marching to a postwar record in 1998 when the government intervened. This move enabled banks to continue to support companies that may have looked less than creditworthy without a guarantee of repayment.

Chief among the LDP's sources of concern were construction firms, which were having a hard time getting banks to roll over their loans after the banks themselves had to worry more about the probabilities of being repaid. The credit-guarantee program had the desired effect as business failures fell sharply after the infusion of new funds.

Fiscal Conservatism

The government's fiscal condition deteriorated badly in the 1970s as a recession triggered by the surge in oil prices drove the budget into persistent deficit. Declaring the 1980s to be a decade of recovery, MOF took radical steps to achieve a balanced budget. That goal was reached in 1990, and politicians and bureaucrats alike fervently tried to remain on the path of fiscal rectitude. However, as early as 1993, experts had concluded that public funds would be needed to help clean up the bad-loan problem. The only questions were when, how much, and in what manner? MOF policymakers, though, desperately fought the idea of nationalizing the losses incurred by the banking system as they attempted to adhere to their no-deficit policy.

In 1995, after seven *jusen* (housing finance companies) that were affiliates of large banks got into trouble, the administration of then-Prime Minister Tomiichi Murayama came up with a plan to bail them out. Aside from the ramifications for the founding banks, the major motivation for this policy shift was to assist agricultural cooperatives that had invested heavily in these companies and that were about to lose much of their money.

Losses at the cooperatives meant that farmers—another key LDP constituency—would lose their deposits. Politically, the bailout was particularly clumsy. It appeared to taxpayers that their money was being used to protect a small number of the LDP's friends. The political opposition seized on the issue and organized rallies at the Diet, holding up consideration of other legislation for months. This experience made the LDP leaders extremely skittish about any new program to deal with the bad-loan situation that involved a public bailout.

Business Sources of Delayed Response

Investment Rules of Thumb

Thirty years of rapid growth left corporate Japan with business practices that hampered its ability to respond to a permanent economic slowdown. Investment and expansion had been the primary objective of business. In the 1950s and the 1960s, growth was so rapid that the main problem facing business leaders was how to manage the process.

Bringing new, productive capacity on stream was a constant challenge. Profits for the most part were invested rather than distributed to shareholders as dividends since such a move would have required firms to go into the capital market or to borrow from banks to raise the money for expansion. Moreover, it made little sense for businesses to make fine-tuned calculations of internal rates of return when economywide returns averaged 35 percent or more in the 1950s. However, as growth gradually slowed, established business practices diverged more and more from profitmaking rationality.

Lifetime Employment

Recruitment, retention, and training were persistent problems during Japan's high-growth years. One development to cope with these challenges was the entrenchment and the refinement of lifetime employment among large companies. The spread of this feature of Japanese business practice largely was a product of the 1950s. Before that, labor relations had been turbulent. Lifetime employment and the accompanying practice of promoting people based on age and tenure served several critical purposes. They encouraged investment in human capital, produced cadres of new managers knowledgeable about the intricacies of fast-growing big companies, and tied scarce labor to the firm. The fact that the employer had a commitment to its employees for their entire careers was not seen as a problem.

Although lifetime employment formally applied only to some 25 percent of the labor force, most firms tried to follow the practice. Of course, not all companies could afford to do so. It was especially difficult for smaller firms in competitive industries. Nevertheless, the norm of lifetime employment had a noticeable effect on nationwide statistics. The variation of employment in response to changes in output in Japan is roughly a quarter of the fluctuation in the comparable U.S. statistic.

Long-Term Business Relations

A corporate practice in Japan that has been widely cited as worthy of emulation is the effort to build long-term relationships among companies that do business with each other. Such ties can have many positive effects. For example, supplier firms can make investments confident of demand for the resulting product. Companies also can coordinate their activities more closely than if they engaged in arm's-length transactions. On the downside, however, if a business partner becomes less competitive than other potential partners, the relationship is maintained at a price.

While corporate America has learned many positive lessons from Japanese intercompany relations, firms in Japan now are learning to end relationships that no longer make economic sense. Such a radical change in the business environment takes time to implement, however. As with their commitments to employees, many Japanese executives consider it a matter of honor to continue to support alliances as long as possible. That loyalty drags out the adjustment process.

Corporate Governance

Changes in corporate control represent one of the main means for forcing business discipline on American firms. Underperforming companies become targets for mergers or takeovers. Moreover, insolvent companies can be reorganized through bankruptcy to reestablish their underlying value. Corporate governance in Japan, however, has been particularly weak. In part, this situation is an outgrowth of an explicit policy dating back to the early 1970s when corporate cross-shareholding relationships were promoted to foster long-term ties and to thwart unwanted takeovers. The absence of outside directors on company boards and the high price of underlying assets, particularly land, are other impediments to more profit-oriented corporate governance in Japan.

Many of the conditions that have discouraged strong corporate governance in Japan are changing. Companies are selling shares that do not yield adequate returns. Boards of directors are becoming more open. Property prices have fallen for a decade, and share prices are at more attractive levels. Most importantly, corporate financial officers must pay greater attention to returns on capital. That requirement opens up possibilities for greater competition for the control of underperforming companies and for the restructuring that would be the likely result.

The Turnpike Theorem and Its Side Effects

The policies and attitudes just mentioned originally were innovative, rational, and profit-maximizing approaches to attaining high-speed growth. On a broader front, Japanese policymakers were ahead of economic theoreticians in their growth policies. Economists developed the so-called turnpike theorem in the 1950s. Under certain conditions, they posited, it would make sense for a nation to reconfigure its economic structure to emphasize rapid investment and production growth while sacrificing current consumption. It might pay to take a detour to get on the turnpike and zoom along at high speed before taking the exit ramp marked "increasing consumption." For developing economies, an emphasis on investment and production often is an appropriate policy for achieving the ultimate goal of consumer welfare.

Japan is living proof of the turnpike theorem's validity. What the economists formulating this idea did not foresee, however, was that the highway to growth easily might become a road to nowhere, with the exit ramps blocked by structural inertia and political barriers protecting the status quo.

Another barrier to change is economic obsolescence—an unwelcome fact of life that policymakers understandably try to avoid, especially when resources still are quite capable of performing their former tasks. Markets are the usual means for assessing the value of assets in changing circumstances, but the results often are troublesome if they imply hardship. And adjustment inevitably imposes economic and political costs. When government is involved in a hard-hit industry or when firms and workers are regionally concentrated or have enjoyed excessive benefits (often from protection or regulation), the political pressures to provide "good jobs for good people" become particularly difficult to resist.

In addition, the routines of business decisionmaking that had been consistent with economic rationality under past conditions block adaptation when it is not patently obvious that conditions have changed sufficiently or permanently so as to make old methods obsolete. The combination of this natural tendency to persist with successful strategies and the conservatism of institutions developed to respond to rapid growth is a recipe for delayed response.

However, countermeasures to inertia do exist. One aspect of recent Japanese experience that has promoted greater sensitivity to shifting patterns of demand is the deregulation of the financial services sector and the increasing role in the economy of foreign businesses that are not burdened with the obsolete lessons and methods of Japan's past. In particular, liberalized financial markets and the loss of the government guarantee to protect banks from their bad decisions have introduced an appreciation for profitability that was missing before.

The seemingly wasteful destruction of firms and the dissipation of their resources, including career employees, by the mysterious actions of market forces often appear to be a high price to pay for growth and productivity. However, although it can buy several years' time, failing to make needed changes is not a sustainable long-term policy.

Ultimately, the choices are deeply political. The promotion of vigorous financial markets—itself a political choice—can go a long way toward bringing economic forces to bear on business and political judgments. This is happening in Japan today. Business is restructuring at a rate that, from an American perspective, looks slow but that cumulatively could change the landscape of Japanese society.

Notes

1. Decade-long periods were used to reduce the effects of such short-term fluctuations as business cycles. Growth rates for subsequent 10-year periods were calculated for all 21 countries with real GDP per capita of more than $10,000 in 1985 purchasing-power parity. However, three countries whose national income depended mainly on oil exports were excluded. An individual country could appear several times in the sample. Robert Summers and Alan Heston, "The Penn World Table (Mark 5): An Expanded Set of International Comparisons: 1950-1988," *Quarterly Journal of Economics* (May 1991). Updated version available at http://datacentre. epas.utoronto.ca:5680/pwt/pwt.html.

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8. The total comes from various news articles, plus Hall, 160-165.

9. Organization for Economic Cooperation and Development, *OECD Economic Surveys: Japan, 1996-1997* (Paris: 1997), 67.