THE JAPANESE ECONOMY AND ECONOMIC STRUCTURAL ADJUSTMENTS*

By CHIKASHI MORIGUCHI

1. Introduction

It might not be appropriate to choose such a title as above for a presidential address at this academic convention. But, there are several reasons for choosing it. First, I have engaged in macroeconomic analysis of the Japanese economy in the past twenty years, covering from economic forecasting with econometric models to formulating policy proposals. Throughout this period the Japanese economy has shown a variety of economic structural changes and I have struggled to cope with them in econometric model building efforts. In other words I, as a quantitative economic analyst, have lived with economic structural changes of the Japanese economy.

Secondly, by participating with a policy study group engaged in designing a better-performing economic system (or a subsystem), I came to know that institutional changes are inseparable part of economic structural changes, and that the latter tend to lead the former. From my experiences I hope I might be able to say something new in assessing the Government's recent policy called Economic Structural Adjustments.

2. ESA Policy in a Historical Perspective

Economic structural adjustment is a rather new term in the history of public policy in industrialized countries. It does not appear in an economic dictionary of which I was one of the joint editors. Officially it first appeared in 1986 when a policy package was recommended by a committee to Prime Minister Nakasone as a measure for reducing Japan's large external imbalance at

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that time. The committee chaired by the late Mr. Maekawa, a former President of the Bank of Japan, was named Study Committee for Economic Structural Adjustments.

Incidentally, one can find a similar term in the dictionary such as "structural reform" which was a term that had a close association with a practical reform plan proposed by the Italian Communist Party led by Berlinguer; or "structural improvement," a term used by the Ministry of Agriculture implying modernization of Japanese farms.

During the 1960s industrial adjustment policy was frequently mentioned of. It was a precursor to economic structural adjustments policy, but far from identical. A positive adjustment policy (PAP as it was often referred to in papers written by the economists of OECD Secretariat) meant a forward-looking industrial policy that should accommodate economic structural changes and increase the prospects for economic growth without inflation; man-power policy or science and technology policy are typical examples. Industrial adjustment policy could not avoid a role of mitigating social cost caused by fast economic structural changes by decelerating growth, which was an negative aspect of adjustment policy.

The adjustment policy in the 1960s was closely associated with Keynesian (or Post-Keynesian) economic policy. Industrial structural policy was to remove some of the structural obstacles for the compatibility of full employment and price stability. However, the Keynesian policy had already begun to lose efficacy owing to low flexibility of the Western world's economic system. The cost of sticking to full employment by the so-called fine-tuning of fiscal and monetary policy became clear as the Phillips relation between unemployment and inflation rate was decayed.

After the stagflation of the mid-1970s, a new monetarist-oriented economic policy dominated the sphere of economic policy-making. It put a strong emphasis on controlling inflation and almost paid no attention to a short-run policy target of full employment. It aimed at a recovery of equilibrium from a medium-term point of view. Here economic recovery meant not only halting inflation and regaining full-employment, but also it meant a reestablishment of flexible economic system through deregulation policy and privatization of public corporations (in the case of U.K.).

The so-called "supply-side economics" of Reagan and the neo-conservatism policy of Thatcher prevailed; the latter was characterized by privatization and reform of rigid labor relations and the former by a combination of deregulation and tax reduction. The evaluation of these policies is not my topic here, but I should like to stress that they exerted a profound influence on policy makers in other countries including Japan. They were not called economic structural adjustment policy at that time, but should be recognized as such in retrospect. Economic structural adjustment and neo-conservative reevaluation of the free market system are two sides of the same coin.

3. Japan's Public Policy in the 1980s

The strong influence of neo-conservatism is quite apparent in the recent Japanese history of economic policy. The primary targets of public policy in the first half of the 1980s were twofold: restoring of fiscal balance and administrative reform. But the principal target for the fiscal authorities seemed to be the fiscal balance that was in a large deficit as early as 1980, a result of the expansionary policy of 1977-78, and lowered economic growth potential due to high energy costs and the world-wide disinflation policy. Mr. Ohira, Prime Minister at the time of second oil crisis,
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challenged the deficit problem in a straightforward manner by appealing to the public that a VAT was necessary. He subsequently lost in the general election of 1981.

Mr. Nakasone, his successor, had been Minister of Public Administration of the Suzuki cabinet, under which a council for administrative reform was established. At that time three major sources of deficit on the side of public expenditures were: 1) national railway system, 2) the special account of food supply control (mainly subsidizing rice production), and 3) national medical insurance system. The three “Ks” (kokutetsu, kome, and kenpo) were draining money out of the national treasury, and they formed a set of very visible targets for administrative reform and deficit reduction.

The last “K,” the medical care insurance system was radically restructured by raising the ratio of patient's co-payment and by lowering the authorized maximum price of medicine such that it reflects a downward trend of production cost.

The second “K” is still not resolved, but the growth of the special account deficit was checked by the narrowing of the gap between producers' and consumers' prices of rice. The first “K,” the national railway system, was under a vicious combination of inflexible costs due to rigid labor relation and slowing demand growth due to the rapid pace of “motorization.”

Throughout the struggle with three Ks, the Administrative Review Committee campaigned powerfully for a “small government,” “self-help” (or high welfare, high contribution), and “free competition” as the targets of public policy that aimed at revitalizing of the economy. The ideology of neo-conservatism that dominated the U.S. and U.K. at that time was fully utilized in reshaping Japan’s public policy.

However, the financial authorities mixed a large dose of pragmatism with the new ideology. Their real interest lay in a drastic reduction of the current budget deficit which was allegedly “getting out of control.” They placed an overall zero-growth ceiling on almost all budget items excepting only defense, overseas development aid, and debt service expense. They also sought every possible means to raise fiscal revenue even though there were no major attempts to introduce a new tax until 1989.

The fiscal authorities were successful in making “fiscal reconstruction” their number one public policy target. This success, however, resulted in a policy-created drop in the expected rate of Japanese economic growth. While the private sector was struggling to streamline production line and to strengthen R & D activity along the microelectronics revolution, a contrasting change took place on the U.S. side. The U.S. economy began to expand under a policy-mix of tight money and fiscal ease, a switch to Keynesian type expansionary policy under the name of “supply-side-economics.” Under a prevailing strong dollar there came an unprecedented explosion of the U.S. trade and federal budget deficits. Under a consistently stringent fiscal policy the Japanese economy returned to export-led-growth. This growth was an unexpected benefit to the manufacturing sector. Actually, an almost classical process of a vicious circle of stringent fiscal policy and low growth of the economy gave way to the export-led-growth. With economic recovery the fiscal deficit began to shrink and some of the public sector reform plans could be implemented.

Prime Minister Nakasone’s Economic Structural Adjustments Policy was formulated as a emergency measure to deal with the expanding external imbalance. Besides its short-term
expansionary policy for stimulating domestic demand, it consisted of an interesting set of "structural adjustments" measures. In order to enhance the relatively low standard of living of urban workers to the level that compares with high labor productivity, it declared that the government would take up various measures to 1) remove any institutional factors which contribute to raising the saving ratio; 2) slash the wide differentials between domestic and international price of consumer goods and services by encouraging the distributive industry to be more competitive; 3) reduce working hours of workers to create increased leisure.

The ESA Policy package is not really a set of implementable policies in the sense of ordinary economic policy. The policy authority in charge of respective policies was not necessarily identified and policy targets were deeply involved with underlying characteristics of the Japanese society. However, as a total policy action, it has exerted a profound impact on the contemporary Japanese economy and society. I should like to discuss some of the problems which are related to expected and unexpected outcome of the ESA Policy since 1987.

4. Economic Structural Change—an econometrician's view

Now let me turn to examine some of the meanings of economic structural change. In a simple taxonomy of the term, it has the following meanings:

1) A compositional change of economic structure: it simply represent a disproportionate change in the composition of industrial output, trade, and employment. It is a structural change that can be endogenously explained by a multi-sectoral growth model. And to that extent, it is not really a category we are interested in.

2) It includes institutional changes which induces changes in economic behavior: we usually identify such changes as changes in the structural parameters of econometric equations. A change in taxation has an impact on household's decision between working hours and leisure time. Institutional changes can affect relative prices of consumer goods and causes an economic structural change of type 1) above.

3) Changes in microparameters of economic behavior: Changes in the personal saving ratio, or the corporate propensity to invest, etc are usually outcome of a change in an economic entity's expectations about the future, and they often produce a substantial change in macroeconomic balances.

4) Lastly, a change in characteristics of statistical distribution of microeconomic variables (such as income and asset distribution, or profile of age distribution of population) reflects a major structural change of an economy. This again produces changes in expectation and leads to type 3) structural changes. Particularly, when information on asset distribution feeds into one's utility function, behavioral parameters are affected by a change in relative income/asset status.

Looking at structural changes in this way, we might say that an essential economic structural change is what brings out a change in one's expectation, or perhaps a phenomenon that changes the process of expectations formation. In this context, I should like to take up the following case as a good example to reinforce the above statement.

The recent land price surge in Japan first took place in Tokyo and was accelerated by the massive monetary expansion which took place after 1986. It was followed by stock price increase that
culminated towards the end of 1989. According to my estimate, the total private sector of Japan amassed a huge capital gain as large as 600 trillion yen during the three year period of 1986–1989. On the other hand, the total amount of personal savings in national income account was 108 trillion yen for the same period. This caused a substantial and unexpected rise in the average asset/income ratio of household. A decline in personal saving ratio observed in this period may well be explained by this change.

The rise in the asset/income ratio was also reflected by a surge in private housing investment in this period. Those who sold land and obtained capital gains spent some of it in a purchase of new houses, while high land prices discouraged young families who would have to start with own saving and bank loan. The land price inflation apparently brought out a significant change in asset distribution among households classified by age in favor of households with older heads.

The positive effect of capital gains on housing investment could be short-lived partly because of its unfavorable impact on young family households. But a more substantial structural change in the behavior of housing investment may lie in the future. As recent land price trends demonstrate the myth of ever-rising land prices is finally dying. Expected introduction of land tax and strengthening of the present real estate tax, coupled with tight money policy, will bring down the level of land prices nationwide, and particularly so in the metropolitan areas where massive speculation occurred.

Once the myth is broken and the new taxation scheme encourages renting a house or apartment, housing investment behavior will shift from the present tendency of “own house on a large debt” to a new norm of “rent-house plan according to one’s own stage of life cycle” in which the proportion of housing demand for renting purpose will increase. This will provide a good example of how a change in expectation can bring about a significant structural change in economic behavior.

5. Driving Forces of Economic Structural Change

Then what are the basic factors that cause expectational change? In the context of our medium term econometric model analysis, they are usually those exogenous factors such as the followings:

1) Price shock: a change in relative prices such as an energy price shock can have a profound impact beyond the expectation of the informed economic entities (including the policy authorities).

2) Technology shock: Technological innovation is another crucial factor. It consists of the new technology itself and of the speed of its propagation in the economy. The fast progress of the “microelectronics revolution” in the eighties was beyond expectations both in its speed as well as in its wide impact on most industrial sectors.

3) Environmental and demographic factors: a realization that economic growth is constrained by certain external limits of supply leads to a change in the basic framework of understanding economic affairs.

These factors may well be treated endogenously in a long-run theoretical model, but in terms of the present context, they are exogenous. Here we are concerned with a role of structural adjustments policy by a policy authority with imperfect foresight.
If we compare the trends of relative price changes in the last two decades between Japan and the U.S., we find that Japan has had to cope with far larger shocks. Energy price shock was bigger for Japan than for the U.S. It was because of the fact that the U.S. has a rich endowment of oil and natural gas, let alone, of coal, and domestic energy industry is somehow protected from a free fluctuation of energy price in the international market.

When we look at a relationship of wage rate versus capital goods price in the two countries, it is surprising to note a contrasting fact that wages deflated by fixed investment deflator show a marked upward trend through the recent two decades in Japan, while remaining almost flat in the U.S. One may say that the Japanese wage rate was simply low to start with. It goes without saying that Japan's strong upward trend is an outcome of fast economic growth, but it is also the case that rising real wages (over capital good price), or a rising capital cost was a driving force of Japan's high investment rate.1) The strong trend also reflects a higher decreasing rate of capital good price. Even though the both countries realized high rate of technological progress in microelectronics, Japanese manufacturing industry seems to have benefited more from it than the U.S. manufacturing did. The U.S. industry's fixed investment is more diverse (from oil search to aero-space and military) than the Japanese, and its lower intensity of market competition should explain a slower rate of decrease in capital good price. This point again leads us back to the role of relative price shock.2)

Japan's high rate of structural change was clearly accelerated by the fast change in trade pattern and the latter was further encouraged by the industrial policy of MITI that anticipated correctly the course of structural change in most cases. As I touched upon at the beginning section MITI's industrial policy is to be distinguished from the ESA Policy here, but the two share a characteristic in common that an economic policy related to structural changes could be effective when it foresees a direction of change correctly and it successfully influence the expectation formed by economic entities.

In the case of ESA since 1986, almost all of structural changes were realized through market forces driven by a large price shock resulting from the massive appreciation of the yen rate. Consumer access to imported goods was improved substantially by some policy actions, but access improvements were mostly realized through market forces. In fact, so far evidences is lacking to support the view that Mr. Nakasone's ESA Policy was effective. For instance when we look at the trend of working hours, we only find that ESA Policy which neglects to see the basic characteristics of Japan's socio-economic structure, is simply ineffective.

1) The late Prof. T. Watanabe once pointed out that Japan's postwar economic growth is characterized by the fact that it pursued capital-intensive or labor-saving technical progress while Japan was abundant with labor supply. Apparently this process continued even after Japan reached a labor-short stage in the mid-sixties. On the other hand during the seventies and eighties the U.S. industry pursued a reverse course by investing less in manufacturing industries (importing more from abroad).
2) G. Saxonhouse (1989) conducted an interesting study on the speed of structural change in trade pattern. He estimated a model of comparative advantage over major countries with natural resource endowments taken into consideration. Based on the estimated model he ran a simulation under a fictitious assumption on natural resource endowments (such that Japan owns the whole Alaska) and showed that with more biased natural resource endowments the rate of structural change in trade pattern tends to be higher.
Long working hours of Japanese workers were one of the hot issues raised in the Maekawa Report. Overall rough estimates say that average worker in Japan works twentyone to twentytwo hundred hours a year, in comparison to nineteen hundred for American workers and less than seventeen hundred for Germans.

Working hours are a rather difficult matter for international comparison. They vary among industries where the relative population of regular workers, male or female, varies. A growing population of part time workers in service sectors gives a misleading impression that average working hours are becoming shorter.

Yet I would not deny that the Japanese workers tend to work or at least tend to stay at working place for longer hours than the European and American workers. In addition, however, other evidence that indicate the Japanese workers are working longer than the statistics indicate.
White-collar workers tend to work longer hours, and some of their overtime work is neither fully paid nor reported. Basically, contracted weekly working hours in Japan are now about forty to forty-two as compared to thirty-five in Germany. A large difference of working hours between Japan and Germany cannot be explained by the difference of contracted working hours. A hundred hours difference should be explained by two factors: 1) difference of overtime working hours and 2) difference of paid no-work days that actually "consumed" by workers.3)

The Maekawa Report recommended that government address the issue of shorter working hours as one of the targets of ESA. The report seems to have tacitly agreed with criticisms made by foreign governments on the long working hours as a potential source for Japanese industry to overproduce and to dump products abroad. But a primary reason was that it anticipated that shorter working hours will provide more leisure time for workers and hence stimulate consumption expenditures!

What has happened to working hours actually in Japan since the Maekawa Report? As the economic recovery developed into a strong expansion from 1987 to 1988, firms responded to rising demand for products by extending overtime working hours of employees. Employees were willing to accept these hours. As several surveys on factory workers about their preferences on "more leisure or more income?" indicate, most workers, particularly those who are over thirty and have family, prefer more income to more leisure.4)

The government campaigned for shorter working hours through the total shift to "five working days a week." In 1987 the public sector and banking sector moved to 50% shift to it by taking two Saturdays off monthly working days. But statistics show that total working hours have not been reduced nevertheless. In the banking sector average overtime hours were extended to make up for the loss of Saturdays.

As the economic expansion turned out to be long-lasting and business firms anticipated a labor shortage, the rate of increase in employment rose in 1989 and the total working hours came down slightly. But the rate of consumption of paid holidays is not increasing.5) When we look into small firm situations in this question, we learn that there exists a wide gap in working hours between large firm employees and small firm. Small firm employees tend to work longer with lower wage rate. The five-days a week system had long been established at the factories of large firms of Japan.

The wage differential between large and small firms was a symbol of the "dual structure" thesis in the sixties. It vanished throughout the seventies when the Japanese economy shifted from a "labor-abundant" to a "labor-shortage" economy. However, during the stagnant years from 1980

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3) Perhaps a difference of two hundred hours between American and German workers could be attributed to the difference of contracted weekly hours.
4) Most frequently cited reason for this preference was that they need to work more for income to pay back housing loan. Young workers are different. Their job turnover rate is high, and they tend to prefer higher hourly wage and no overtime works. A relatively steep age-profile of wage seems to underlie in this contrasting attitude toward income-leisure preference.
5) Traditionally, unmarried female workers tend to take all paid holidays, while male workers who are more tightly knitted into the management system of firms cannot.
to 1986, the wage differential revived again. And basic underlying factors are reflected also in the
difference of working hours. It is said that the introduction of “just-in-time” (or Kanban) system
has widened the gap of working conditions between the “parent” company and its subcontractors.
Experience with the shorter working hours policy indicates that it is practically impossible for
the public authorities to pursue the policy rigidly, for instance, by introducing some measures
to force firms to cut overtime hours, and to force employees to consume their paid holidays com-
pletely.6) The problem is how to enforce these measures to small firms. This policy runs coun-
ter to the anticipations of small firms which have traditionally been protected by the public
authorities.

One might ask, “Why not let competition force them to match wages and hours?” Actually if
competition among firms is conducted on the basis of common wage rate and common working
conditions, monitored by an industry-wide labor union, competition will eliminate less efficient
firms. But this story does not seem to apply to Japan directly.

In Japan competition in one industry is being “fought” by many firms of apparently quite dif-
f erent competitive capacities. Less efficient firms can survive competition in the following man-
ner: each firm is run on the basis of agreement made by management and company union that
accepts existing differentials of wage and other working conditions between the company in ques-
tion and other competitors. The profit rate of that company should be lower than its more effi-
cient competitors and so is the stock price. The most efficient firm restrains itself from pursuing
an aggressive strategy that might eliminate other lesser competitors (possible restraints from anti-
monopoly law and administrative guidance by MITI that fears a “disorder” in the industry in
question.)

Thus there is a larger likelihood that larger number of firms are engaged in Japanese domestic
market than in the U.S. counterpart where wage differentials among firms do not exist or are
smaller if they exist. Competitive pressures (often resembling a “rat race”) tend to be stronger in
Japan, since workers have incentives to work harder for improving their company’s competitive
position. Competition for the sake of relative share of market is serious, and a room for tacit
agreement among a few oligopolistic competitors is small.

At the level of R & D competition, teamwork efforts tend to be poured into catching up with
the technology of competitors or into the improvement of product engineering instead of pursu-
ing basic research objectives. Competitive pressure is so strong that engineers cannot “afford”
fully to consume paid holidays.

At the level of sales promotion, the characteristics of Japanese-style competition is conspicu-
ous. Lots of energy and resources are consumed in a seemingly “zero-sum game” of sales com-
petition among engaged competitors.

Industry as a whole can improve the total efficiency by mergers, but it might lead to a stagna-
tion of research and development to a lower efficiency from the long-run dynamic viewpoint.
Besides, the lifetime employment system of Japan plays a role of as a deterrent to mergers.

6) Some suggests the following measures: 1) raise overtime wage premium from the present 25% to 50%,
2) set maximum overtime hours and prohibit excess overtime work by law, 3) force firms to “buy back”
the unconsumed paid holidays from employees.
Mergers of corporate firms are only possible under the agreement between management and employees union that lifetime employment be guaranteed. In many unsuccessful merger proposals, opposition of labor unions based upon fears of infringement on their "job right" have played a crucial role. Instead of rejecting the merger, unions tend to accept worsening of working conditions in exchange for lifetime job security.\(^7\)

The above-mentioned characteristics of competition in Japan can explain why Japanese firms adapt so swiftly to a growing market. Non-price competitiveness is strong, based upon the joint effort by management and company union which share the risk and fruits of growth.

The same set of characteristics can also explain why the adjustment speed of Japanese firms is so low in the face of a declining market. None of the competing firms exit easily from competition and they tend to be prepared for long endurance of hard times. In this situation of "structural depression," MITI usually intervenes and a "depression cartel" is organized in order to mitigate cut-throat price competition as an exceptional case of Anti-Monopoly Act. The cartel guarantees to competing firms a certain length of period in which firms downsize productive capacity. Mergers are encouraged, while free entry of domestic or foreign firms is restricted. This case applies to many domestic non-trade sectors of Japan. The banking, distributive, and agricultural industries are typical examples.

This tends to protect most of firms in the cartel from a potential competition, giving an excess profit from which an institutional rent is created. Excess profit tends to be distributed to employees (including executive managers) in the form of high wages and salaries, generous expense accounts, and other fringe benefits. Thus the overhead cost of an employee becomes higher and there grows a strong pressure for existing employees to work harder and longer. Pressure for expanding employment is weakened.

Thus, one must recognize that to shorten the working hours of Japanese workers is equivalent to changing the basic style of competition among firms and the so-called lifetime employment system. It necessarily touches upon some aspects of the socio-economic core of Japan. The Economic Structural Adjustment Policy which targeted at shorter working hours, seems to have failed because it ignored deep-rooted source of the problem.

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\(^7\) Professor L. R. Klein once (1977) pointed out that the lifetime employment system as one of major sources of Japan-U.S. trade frictions. Reportedly he claimed that the system tends to produce an overtly expansionary export practice by Japanese firms since they do not pay "due attention" to short-term profit and tend to be more concerned with expanding market share.
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