The Rise and Fall of the Japanese Miracle

By JEFFREY HERBENER

[Posted September 20, 1999]

In 1943, John Maynard Keynes claimed that central-bank credit expansion performs the "miracle of turning a stone into bread." In its attempt to revive itself after a long recession, the Japanese government and central bank have given the world its last twentieth-century Keynesian experiment. It is an experiment that has failed, and miserably so. Not just Japan's history but the whole of economic history this century has shown that Keynes's supposed miracle is a counterfeit producing not higher standards of living, but crises and depressions.

Economic growth requires genuine capital accumulation, i.e., the construction of an enlarged capital structure by saving and investing. The counterfeit miracle of central bank monetary inflation generates only a boom-bust cycle. At first, the credit-expansion appears to be a stimulated process of economic growth. Interest rates fall, capital values rise and entrepreneurs profit by building up the capital structure. The capital construction cannot be completed, however, since genuine saving is insufficient. The boom rests on a lie, viz., artificially low interest rates, and once the lie is exposed, the boom must end and the bust must follow.

Japan has experienced both the genuine miracle of the market and the counterfeit miracle of the state for the past 150 years. International trade with the west began in earnest in the 1850s and the Restoration Government of 1868 supplanted the old feudal system with private property rights and freedom of trade, enterprise, and movement. In the 1880s, Japan sold most state-run enterprises to the private sector and its economy was rapidly integrated into the international division of labor. The thrifty Japanese people provided ample saving for capital accumulation. Countering these forces of genuine growth, the government subsidized transportation and communications, cartelized banking and heavy industry, and established a central bank. In short, Japan imitated the mercantilist system of Great Britain complete with an empire, albeit on a regional scale. The Japanese empire, like the British one, was founded on the international division of labor, in this case with its Asian neighbors, including Manchuria, Formosa, and Korea; but the financing power of Japan's debt and monetary inflation was put into the service of its warfare state. Thus, the rise of Japan to a great industrial power prior to the First World War was part genuine economic growth, part build up for the state, and part boom-bust.

Japan's economic development, like America's, was given a tremendous boost by its policy of neutrality in the First World War. Japan's trade with Asia increased enormously as former trading partners went to war with each other. And like America, Japan inflated during the war on the base of huge gold reserves that were built up by burgeoning trade surpluses. The inflationary boom lasted until 1920 and a deflationary collapse followed. The massive earthquake of 1923 set up the next round of monetary inflation by the BOJ to finance reconstruction spending. That boom came to an end when heavy outflows of gold led to a deflationary collapse in 1927 and was followed by depression until 1931. Just as the Great Depression was gearing up in the West, Japan was embarking on another round of government spending, debt, and monetary inflation. This time the expansion was devoted to building up the army and navy.

For all the belligerents in the Second World War, the conversion to a war economy meant centralized, political control of economic activity. In Japan, it was a natural extension of the military build-up of the 1930s that the cartels in league with the government, would run the war economy since the cartels dominated heavy manufacturing and banking. During the war, control over banking was further centralized in the Bank of Japan and the Industrial Bank of Japan became the financing agent for war production.

So completely was the economy transformed into a war machine that when the fighting ended the productive capacity of the economy was almost entirely worthless for consumer goods production. Tragically, the Occupation Authority which ran Japan after the war prevented economic reconversion. It imposed punitive taxation and labor unions, dissolved the cartels, and confiscated land. More importantly, America poured $1.6 billion of foreign aid into Japan between 1945 and 1949 which permitted the BOJ to further inflate the money stock, already tremendously inflated at the close of the war. Hyper-inflation ensued with wholesale prices increasing thirteen-fold from April of 1946 to March of 1949. Unable to proceed with any large-scale economic reorganization, industrial production in 1948 was merely 40% of its 1937 level and agricultural production was well below its pre-war level.

In 1949, Japan was forced into the new, American-dominated international order. The monetary order of Bretton-Woods fixed the yen-dollar exchange rate at 360 to 1 and required the Bank of Japan to coordinate its yen inflation with the Fed's dollar inflation to integrate credit expansion internationally. The new military order, i.e., the cold-war brought Japan's existing military capacity into production again. Its war machine revived by American military procurements, industrial production in Japan finally surpassed its pre-war level in 1951. Having proved a reliable ally, the Japanese government had its sovereignty restored in the spring of 1952.

By 1953, the reforms of the Occupation Authority were reversed. The unions were weakened, taxes were lowered, the cartels were reformed and government planning strengthened. State control of credit was as strong as ever in the Japan Development Bank, the Export-Import Bank, and the Trust Fund Bureau which had oversight of the postal-saving system. Only land reform survived.

In short, Japan had restored its pre-war, mercantilist economic system, save for its regional, yen trading-block. This was hardly a *laissez-faire* recipe for performing the genuine miracle of economic growth.

For the decades of the 1950s and 1960s Japan served in the American system in a way similar to that of Indonesia in the 1980s and 1990s. The inflow of American dollars and the Japanese government's allocation of funds from the postal saving system boosted the average annual increase in GNP to 9.6% for these two decades, more than double the 4.6% rate for the period 1925-1939.

This productive effort, however, went largely to satisfying government instead of consumer demands. War materials and infrastructure projects were funded at the expense of building capacity to serve consumers. International trade went counter to the pre-war lines of comparative advantage with America becoming Japan's leading trading partner both in exports and imports. Stripped of its place in the inter-regional division of labor, Japan began a program of artificial expansion of domestic production. The Japanese government subsidized production of costly synthetic substitutes for cheaper imported raw materials formerly obtained from Manchuria. Imports of low-priced food declined while the artificially built-up agricultural sector expanded high-priced output. Capacity in steel production, electrical equipment, automobiles, and shipbuilding was heavily subsidized.

Also, part of the post-war economic miracle was counterfeit. American military procurements for the Korean war amounted to some $3.4 billion and set off a domestic boom in the early 1950s. GNP increased 12.1% per year during the war. The BOJ, however, over-inflated the yen, leading to a drain of reserves which, under the fixed-exchange rates of the Bretton-Woods system, could only be halted by a monetary deflation. A short recession followed in 1954 and the next boom was underway by 1955 and suffered the same fate in 1958. Fueled by BOJ monetary inflation, the boom of 1959-1961 saw GNP increasing by 15% per year and ended with a drain of gold reserves in 1961. A short recession followed in 1962, then another boom in 1963-1964 which ended with a recession in 1965. For the next five years, GNP increased more than 10% per year.

Although it required booms and busts, the BOJ was able to coordinate yen inflation with Fed dollar inflation sufficiently under Bretton-Woods that the yen-dollar exchange rate remained at 360 to 1. Exchange rate stability, however, required more rapid inflation of the yen then that of the dollar. With the Japanese economy expanding production at three times the American rate, 19% per year vs. 6.4%, during the second half of the 1960s and early 1970s, the yen was inflated 18.8% per year and still maintained its exchange rate against the dollar which was being inflated only 5.4% per year.

When Bretton-Woods collapsed, the Fed tripled the rate of dollar inflation from 4.4% in 1970 to 12.1% in 1971. The BOJ slavishly followed suit as it had since the Second World War; but yen inflation was not accelerated sufficiently. Even though the yen money stock grew 22.4% per year from 1971-1973 the yen appreciated 22% relative to the dollar from 1971-1974. Price

inflation exploded in 1973 and 1974, with consumer prices rising 11.7% and 23.1%, respectively. A severe recession followed the credit-expansion boom.

After this debacle, Japan began to conduct a more independent monetary policy. The BOJ gradually decreased yen inflation rates to the point where, in 1977, the rate of yen inflation fell below the rate of dollar inflation. But another credit expansion followed with the yen inflating at 11% per year for the next two years and the BOJ lowering the discount rate from 4.25% in 1977 to 3.5% in 1978. Price inflation jumped in 1980, with wholesale prices up 17.8%, forcing the BOJ to contract by more than doubling the discount rate to 7.25% by 1980. Interest rates spiked upward in response, bringing the credit expansion to an end and driving the economy into recession.

Whatever else can be said about the post-war Japanese miracle, it was over in 1970. The average annual increase in GNP from 1971-1979 was 4.6% and from 1980-1990 it was only 4.1%.

Having its monetary policy cut loose from the dollar, Japan attempted, in the 1980s, to reestablish its yen trading-block, albeit with East and Southeast Asia substituting for the old North Asia alliance. In the first half of the 1980s this goal could not be attained since the international demand for the dollar outstripped that for the yen. Despite the BOJ inflating the yen at rates lower than the Fed's inflation of the dollar, the yen declined 24% against the dollar and consumer-goods prices in Japan rose 2.7% per year from 1981-1984.

In 1985, however, the strategy began to be realized. The Plaza Accord that year, in which the leading industrial nations agreed to support a stronger yen and weaker dollar, gave room for an inter-regional yen monetary inflation and credit expansion. The BOJ inflated the yen money stock by 10.5% per year from 1986-1990 and lowered the discount rate from 5% in 1985, where it had been since 1983, to 2.5% by 1987. Japan exported the credit expansion to Southeast Asia and South Korea in the form of direct investment. The massive Japanese investment in Asia was augmented by loan guarantees made by the Export-Import Bank of Japan for investment in and trade with Asia. By the end of the debt binge, Japan was the world's largest creditor nation manifested by having the world's largest banks and had the stock market with the world's largest capitalized value.

Despite the massive yen inflation, the yen appreciated 50% against the dollar from the beginning of 1985 to the end of 1988 and consumer-goods prices in Japan rose only 0.5% per year while wholesale-goods prices fell 4.6% per year indicating that growing yen money demand, international as well as domestic, was absorbing the monetary inflation. But supremacy of the yen was short-lived. Yen demand collapsed in 1988-1989 causing a 16% devaluation against the dollar and a surge of domestic price inflation.

The BOJ hit the monetary brakes, drastically cutting yen inflation from 12.1% in 1990 to 4.1% in 1991 and then to 1.2% in 1992. The discount rate was raised from 2.5% in 1988 to 6% by 1990. The end of the credit expansion doubled interest rates while the reduction in yen inflation helped push up the yen-dollar exchange

rate 22% from 1989-1993.

Japan had experienced what America discovered in the wake of the collapse of Bretton-Woods: generating an international credit expansion succeeds so long as increases in money demand keep price inflation in check. Japan’s restoration of a yen trading-block in Asia was cut short by America reasserting the dominance of the dollar, first in Canada, Mexico, Latin America, and South America and then in Asia and eastern and central Europe. The yen had little chance against the world’s reserve currency and the yen-based credit expansion collapsed in 1990.

Although Keynes is the author of its economic destruction, Japan has looked to him for rebuilding advise.

Japan has tried nine stimulus packages since 1990 totaling $888 billion. Although varied in shape and size, they all have had the same three features: government spending and debt, bailouts, and reflation. Making matters worse, taxes have been raised several times since 1989 so that the government now extracts over 30% of GDP, up from 18% in 1965. The tax cut of 1998 was too small to reverse this trend. But even a sizable tax cut would have only a minimal effect without a corresponding reduction in government spending. A depression will persist until the malinvestments of the boom are liquidated and the capital structure is reconstructed to best satisfy consumers. Fiscal expenditures delay liquidation and reconstruction since government spending always strives to bailout and subsidize the existing production structure.

Moreover, the national debt in Japan was run up to pay for the spending binge, a policy that has further impaired already injured credit markets. Japan's national debt now stands at well over 100% of its GDP, up from 60% in 1993. In 1999, Japan will issue 90% of all industrial country’s net new bond issues, some $352 billion. Its total bond issue in 1999 will be $517 billion and will give Japan the largest debt issue in the world. The burgeoning debt load led Moody’s Investor Service to downgraded Japan’s Sovereign Credit Rating in April of this year as it had top Japanese banks and corporations last year.

Despite Keynesian predictions, mountains of government debt have done nothing to stimulate the economy, GDP fell 2.8% in 1998, or to alleviate private-sector debt. Estimates in March of this year put the bad debt of private businesses at $720 billion which was down only 0.7% from a year earlier despite write-offs. In August of 1998, Japanese banks had an admitted $600 billion in bad loans with another $625 billion loans with higher-than-normal default risk. The banks still had, in July 1998, $1.56 trillion in real estate loans on their books, much of it lent to developers with half-finished hotels, defunct golf courses, and dilapidated rental properties, while real estate prices have fallen 80% from 1991 to 1998. Banks are also still heavily invested in Japanese stocks while the Nikkei was down 64% from 1990-1998.

The government's answer to the financial debacle has been bailout funds. Late in 1998, a $514 billion bailout fund was set up. Funds will go to shore up the Deposit Insurance Corporation, to buy shares of stock in troubled banks and to nationalize, restructure, and liquidate failed banks. For the favor of having the government

become part owner, the banks must cut payrolls, slash overseas ventures, and write-off bad loans. Regardless, fifteen of Japan's top banks lined up for the bailout money. Their fate may or may not be better than that suffered by Long-Term Credit Bank and Nippon Credit Bank which were nationalized in late 1998.

Bailouts have also been extended to corporations. In November of 1998, Nissan Motors requested a $833 million loan from the government-run Japan Development Bank while the Small Business Finance Corp. increased its lending to small business 15% in 1997 and another 11% in 1998 bringing the total to $8.1 billion.

The government has also attempted to bailout its interests in Southeast Asia and South Korea which were built up during the boom. As late as 1997, Japanese banks held 38% of the total outstanding foreign corporate debt loans in Indonesia, amounting to $58.4 billion. In Thailand, Japanese banks held $37.5 billion in debt while American banks held only $5 billion. Enterprises in South Korea had borrowed $25 billion from banks in Japan. In response, Japan provided $20 billion in bailout money to guarantee bank loans made to interests in Thailand, Indonesia, and South Korea.

The Bank of Japan has tried reflation throughout the 1990s. The discount rate was lowered from 6% in 1991 to 0.5% by 1997. But the banks refused to expand credit and instead simply absorbed the new money to hold as reserves against bad loans. Blocked from domestic credit expansion, the BOJ tried to expand Japanese bank credit overseas with the yen carrying-trade. Investors borrowed yen at low interest rates, converted the yen to dollars and other currencies and bought higher-return assets overseas. This put downward pressure on the yen which increased the profitability of the strategy. The yen carrying-trade was active from mid-1995 to mid-1998 as the yen fell 83% against the dollar, but in July of 1998 the yen began to appreciate again, losses ensued and the trade dried up. This policy exacerbated the financial debacle in Asia by greatly expanding credit for three years and then suddenly shutting it off. The financial debacle in Asia then saddled Japanese banks with more foreign bad debt. In response, they cut foreign lending in the first quarter of 1998 by $244.3 billion or 12%. This cut is the latest in a downward trend that has left the once dominant Japanese banks with the same global market share that they had in the early 1980s.

In this morbid condition, banks are incapable of performing their function as financial intermediaries. Any added reserves they acquire must be used to pay down bad loans instead of expanding credit. From 1995-1998, bank bad loan write-offs were $300 billion while banks reduced their loans 2.7% from September of 1997 to September 1998 and another 5.4% from May 1998 to May 1999. This is why enormous increases in the monetary base, 10% from mid-1997-mid-1998, have had little effect on broader monetary aggregates, which rose only 3.5%. Keynesians have mistakenly viewed the impotency of the BOJ as a liquidity trap. But the failure of reflation to generate another credit expansion is not the result of investors hoarding money because they all expect interest rates must rise from their low levels. It is the enormous burden of their bad debt that leads banks to hold cash instead of expanding credit. Moreover, it is not the lack of animal spirits that

keeps businessmen from investing, but their debt burden, their already excessive and malinvested capital capacity, and the uncertainties of reconstructing the capital structure.

In any case, in 1997 the BOJ had already taken the advise belatedly given in mid-1998 by Paul Krugman to bypass the banks and use newly-created yen to buy bonds directly from private holders. From October of 1997 to October of 1998, the BOJ's holding of commercial paper went from zero to $117 billion. Today, the BOJ is the single largest holder of commercial paper in Japan owning one-third of the total. The Ministry of Finance and the BOJ have also been buying government bonds directly from the private holders. Together they now make up 53% of the $2.22 trillion market for Japanese bonds. And yet the banks are still paralyzed and the economy still slumping.

Moreover, risk-adverse savers have been shifting their funds away from banks and into the postal saving system, giving the government even more scope to circumvent the banks. In recent years funds in the system have been increasing at 9% per year so that today $2 trillion, which is more than the total savings in banks and one-third of all savings in Japan, is under government control. Not surprisingly, bureaucrats have squandered the funds. In 1997, for example the government channeled $5.3 billion into building a high tech bridge-tunnel spanning Tokyo Bay that will, by the government's own estimates, suffer losses until the year 2038. Constructing more loss producing ventures is hardly the remedy for depression.

While government spending, bailouts, and reflation serve only to prop up the malinvestments of the boom and further delay the reconstruction of the capital structure, reconstruction is inevitable in a market economy since it functions to satisfy consumers. Bankruptcy, mergers, acquisitions, restructuring, and deflation are the means the market uses to liquidate the malinvestments. Some of these forces have been waxing in the last two years. Bankruptcies in 1998 averaged 1600 per month and mergers and acquisitions have been on the rise in 1999. In April, holding companies, long suppressed by anti-trust laws that the Allies imposed after the Second World War, were reborn. Alliances between foreign and Japanese banks began in late 1998 and, although most bank mergers have occurred among smaller, regional banks that have not had access to bailout funds, a mega-merger was announced last month which will combine three of the large Japanese banks into a world-class sized concern with $1.3 trillion in assets. Even though the government has subsidized the merger, the new bank will restructure by cutting 17% of its work force to eliminate the $8.7 billion in losses the three banks suffered in the year ending last March.

Other restructuring plans will help reallocate labor. NEC Electric Co. announced an 11,600 worker layoff in February of this year and overall, in 1998, the number of jobs in Japan fell by 480,000. Moreover, workers across Japan are being asked to take early retirement or cuts in compensation by the method of "shoulder tapping" an example of which is asking older office workers to chop wood.

Labor like capital, is misallocated during the boom and must be reallocated during the bust. But unlike capital, which is relatively

specific, labor is relatively non-specific and thus, more easily transferred into other productive uses. In Japan, excess capacity reached 30% and was particularly acute in steel production, metal-working, construction, automobiles, and petroleum where the malinvestments of the boom were concentrated.

In contrast, unemployment has risen only to 4.9% from its average rate in the 1980s of 2.5%. The resilience of the Japanese job market comes from the flexibility of market compensation. Unions are too weak to maintain wages in the face of business losses, especially in medium- to small-sized firms. Although lifetime employment has little significance on unemployment, government "employment adjustment subsidies" to companies who keep employees on the payroll as "window sitters" distort official unemployment figures downward making the unemployment picture look brighter. But, like bank and business bailouts, these subsidies delay reorganization of production and prolong depression.

But whether the unemployment figure is distorted or not, Japan's experience clearly demonstrates the fallacy of Keynesian explanations for depression. Krugman, for example, has argued that a depression occurs when the stock market crashes causing consumption to fall which reduces production causing unemployment which reduces income which causes consumption to fall further, etc. But Japanese workers have not seen unemployment driven reductions in their incomes.

Moreover, contrary to Keynesian concerns about underconsumption and oversaving, saving rates have been falling for the last several decades in Japan and have continued to fall during the depression. Net household saving was 13% in 1997, 12.2% in 1998 and this year stands at 11.5%.

Although the Japanese government appears to be permitting some market forces to operate more fully, it steadfastly refuses to unleash deflation. The desperate attempts by the BOJ to reinflate by circumventing the banks illustrates the government's resolve. Yet, this policy, too, depends on the dubious logic of Keynesian economics according to which declines in aggregate demand cause prices to fall which, since costs cannot adjust downward, generate losses and thus, production cutbacks and unemployment. But, monetary deflation and credit contraction during a depression are the necessary financial aspect of the general liquidation of the boom's malinvestments which were caused by monetary inflation and credit expansion. The epicenter of the financial boom and bust is the banking system. Just as the malinvestments and misallocations of the boom move along the lines of profitabilities distorted by monetary inflation and credit expansion, the reinvestments and reallocations of the bust follow the corrected pattern of profits and losses in the wake of monetary deflation and credit contraction. Efforts by the central bank to paper-over these losses with reflation delay their realization and paralyze the functioning of banks and work at cross purposes with the government's relaxing grip on the other market forces of liquidation.

Losses during a deflation are not caused by the Keynesian bugbear of falling aggregate demand but by the mismatch of particular demands, by consumers for particular consumer goods and by

entrepreneurs for particular factors of production, with the existing array of costs of production within a production structure filled with malinvestments and misallocations. These losses of the bust are the reverse of the abnormal profits earned during the build up of the boom and are concentrated on the owners of capital, not labor, since being more specific to each production process prices of capital goods, and to a lesser degree prices of land, decline relatively more than wages. This is how costs of production fall in a market economy to restore or maintain profit even in the face of declining prices of consumer goods. If the government props up the prices of capital, land, and labor, then losses will be crystallized, unused capacity and unemployment will emerge, and liquidation and reallocation will be halted.

Despite lamentations about deflation, the BOJ has followed Milton Friedman's advise and increased the money stock sufficiently to keep prices in general from either rising or falling . The yen money stock has increased 2.8% per year from 1991-1998 and the consumer-goods price index has been stable. And the BOJ had already heeded Friedman's call for increased monetary inflation which he belatedly issued in December of 1997 by raising the rate of monetary inflation from 3%, where it had been every year since 1994, to 5% in 1997 and 4% in 1998. In response to this monetary stimulus GDP fell 0.5% in 1997 and fell again by 2.8% in 1998 whereas in 1996 with slower rates of monetary inflation behind it GDP increased 5.4% and in 1995 it increased 2.5%.

Moreover, the BOJ's first reflation of the 1990s caused consumer-goods prices to rise 2.4% per year, from the beginning of 1990 to the end of 1993. This is three times the rate of price inflation during the boom, from the beginning of 1985 to the end of 1988. And while, wholesale-goods prices fell 0.8% per year in the early 1990s, they fell 3.75% per year in the late 1980s. If America's experience in the 1920s was not evidence enough, Japan's in the 1980s demonstrates once again that stable price indices are no panacea for the boom-bust cycle.

Let us hope that the legacy of Japanese debacle is the acceptance of the lesson Ludwig von Mises taught us in 1912: that the Keynesian miracle of central-bank monetary inflation and credit expansion is counterfeit and must end in crises and depressions.

* * * *

JEFFREY HERBENER teaches economics at Grove City College and serves as senior scholar at the Ludwig von Mises Institute. This talk was delivered at "Austrian Economics and Financial Markets" in Toronto, Canada, September 17, 1999.

BACK

To subscribe to Mises.org's **Daily Article**, enter your email address.

Subscribe
Unsubscribe
Submit

^ Top of Page

Send this page to a friend or associate

To: (Enter the email address)

From: (Enter your email address)

Comments:

Send

518 W. Magnolia Avenue
Auburn, Alabama 36832-4528
(334) 321-2100 -- Phone
(334) 321-2119 -- Fax
mail@mises.org

Contact Us

Home | About | Email List | Search | Contact Us | Periodicals | Articles
Coming Events | News | Resources | Catalog | Shopping Basket | Contributions

© 2001 *Mises*.org **Database Programming, Site Design and Hosting IWDC, Inc.**