Richard A. Werner, *Princes of the Yen* Peter Myers, June 12, 2005; update July 18, 2013. My comments are shown {thus}.

Write to me at contact.html.

You are at http://mailstar.net/werner-princes-yen.html.

Princes of the Yen is about the role of Japan's central bank in the "miracle" years and the recent "crisis" years.

It is also about banking, and central banking, in all countries. A primary source.

(1) *Princes of the Yen* (2) Reply to *Princes of the Yen*

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Endnotes and charts are excluded here.

This book explains much of what was going on at a high political and economic level, but hidden, during the past 50 years, information that should be available to the citizenry to help their decision-making as is supposed to occur in a democracy.

Werner writes, 'Noguchi and Sakakibara were the first and only public figures to clearly identify and acknowledge **the true nature of Japan's economic system**. They called it **the "wartime system for total economic mobilization."'** (p. 80).

Only serious researchers will bother reading this material, and they will want the book - for the endnotes, the charts, the missing text, and something tangible to keep and show others.

Buy *Princes of the Yen* new at http://www3.addall.com;

order second-hand copies at http://dogbert.abebooks.com/abe/BookSearch?an=richard+werner&tn=princes+yen.

(1) Richard A. Werner, *Princes of the Yen* (M. E. Sharpe, Armonk, New York, 2003)

{p. ix} MoF, the Finance Ministry, is generally held responsible for the most flagrant economic mismanagement in modern peacetime Japanese history: the creation of the bubble of the 1980s and the long recession that followed in the 1990s.

{p. x} The recession had produced the general conviction that Japan's old economic system, headed by its leading bureaucracies, did not work anymore and thus had to be reformed drastically. Most commentators now claim that structural changes are "badly needed." Prime Minister Junichiro **Koizumi's most repeated slogan is "No recovery without structural reform."** Senior members of the Japanese central bank have been calling for far-reaching structural reform on an almost daily basis. These voices claim that liberalization, deregulation, and privatization, in other words, the introduction of U.S.-style capitalism, is necessary for Japan's economy to recover.

But is it really necessary to abandon Japanese-style capitalism? One would think so, when considering the dismal performance of the economy during the 1990s. But it is strange that **Japan's economic system was far more closed, cartelized, and controlled in the 1980s, and yet nobody complained that its economy was growing too slowly then**. The same applies to the **1950s or 1960s, when an almost completely cartelized economy delivered double-digit growth**. Moreover, the U.S. economy itself still suffers from business cycles and downturns. It seems, then, that the same economic structure can deliver high or low growth, and growth performance depends on other factors as well. This book shows that the Japanese recession was indeed due to the main force driving the business cycle - money. It is not by coincidence that the main proponents of structural change are precisely those who are in control of Japan's money.

The Defiant Bank of Japan

The central bank has consistently defied calls by the government, finance minister, and prime minister to create more money to stimulate the economy and end the long recession. At crucial junctures, such as in 1992, 1993, early 1995, and much of 1999, the Bank of Japan (BoJ) **even actively reduced the amount of money circulating in the economy**. This shrank purchasing power, reduced domestic demand, rendered the government's currency intervention ineffective, and strengthened the yen, thus aborting emerging recoveries. Lacking sufficiently supportive monetary policies, the government had to rely on fiscal policies. Those were not effective, and instead produced the largest national debt mountain of any industrialized country.

The big puzzle of the 1990s is just **why, despite record unemployment and deflation, the Bank of Japan failed to expand the amount of money further** and thus create a recovery, reduce deflation, and stabilize employment. Sometimes fear of inflation is given as the answer. But Japan has witnessed sharp falls in inflation during the first half of the 1990s and outright deflation in the second. When prices rise and there is inflation, we know that monetary policy is too **loose and too much money is being created. Then the central bank needs to tighten. When prices fall and there is deflation, the central bank has a duty to create more purchasing power**. In general, it is the job of the central bank to create sufficient

{p. xi} amounts of money to keep the actual growth rate close to potential and hence avoid both inflation and deflation.

Given the obvious deflation problem, the Bank of Japan admitted a while ago that fear of inflation is not the reason for its cautious stance. To the contrary, for many years now the Bank of Japan has been saying that it is trying hard to stimulate the economy, noting that **it has**

lowered interest rates to zero. But, it claims, the problem has been a lack of demand for money. Yet it is clear that **the largest demand for money in the world is located precisely in Japan**. First, **the government sector demands record amounts of money to fund its fiscal spending**. Second, the many small and medium-sized firms that are Japan's main employers would like to borrow money. But **the banks, burdened with bad debts, have only been willing to lend to larger, lower-risk borrowers**. That is why the central bank needs to step in and substitute for their lending.

Sometimes the Bank of Japan claims that it is already injecting plenty of money into the economy. But it has mostly **poured its money into the very narrow money market to which only banks have access**. At other times, worries about deflation are countered by its spokesmen with the assertion that deflation is due to desirable structural changes and hence good. But if those structural changes have indeed made Japan's economy more productive, this would raise Japan's potential growth rate, leaving an even larger gap with actual growth. In that case, the central bank would have to create even more money to reduce the deflationary gap.

The most recent argument by central bankers, apparently also backed by the prime minister and his minister of economic and fiscal policy, is that there is **too much "excess capacity" in Japan**. This is true, and another way of putting it would be to say that **aggregate supply is larger than aggregate demand**. But instead of drawing the logical conclusion that **demand should be stimulated** - which the central bank could easily do - the advice is given to **restrict the supply by closing down firms**. Reminiscent of the ill-fated policies of certain depression-era politicians in Japan, Germany and the United States, this "excess capacity" is said to result in "excess competition," which must be dealt with through **bankruptcies**. Ironically, this argument is proposed by the very same commentators who also argue that Japan needs more deregulation, because it suffers from a "lack of competition."

The pattern is clear: While the Bank of Japan's arguments vary - and are quickly changed, when countered - they always come to the same conclusion, namely that the central bank's monetary policy has been appropriate and that the blame lies with Japan's economic structure.

The Bank of Japan Could Have Helped, But It Didn't

Money is normally created by banks. It is precisely because banks did not lend that **the central bank needed to inject more money directly into the economy. It would thus act as the banker to the nation** - as other central banks have done before, and **as, indeed, the Bank of Japan did after 1945**, when banks' balance sheets

{p. xii} looked far worse than in the 1990s. **This worked so well in the years after 1945 that credit growth quickly recovered and the economy boomed.** But throughout much of the 1990s, the Bank of Japan failed to take these tested and tried policies and failed to create enough money for a sustained economic recovery. Moreover, **it has refused to lend to those who needed money most, the government and the small firms. The Bank of Japan also has** had it in its **power to delete the entire mountain of bad debts in the banking system without any costs** to itself, the tax payer, or society at large. Yet it chose not to act. Why?

It is natural to start with the incompetence hypothesis. Incompetence may indeed explain the actions of some of the actors in this drama. The Ministry of Finance, for instance, and the political leaders during the 1990s could have created a recovery simply by changing the way they funded their fiscal expenditure. **Instead of borrowing from the public by issuing bonds - thus draining the money from the economy - they could have funded the public sector borrowing requirement by direct loan contracts from banks. When banks lend, they create money out of nothing, without withdrawing it from other parts of the economy.** This way, fiscal policy would not have crowded out private-sector activity yen by yen, as actually happened. Had they fully understood this, I am sure they would have used this method to create a recovery. However, **this mechanism is litle known among economists, whether in Japan, Europe, or the United States.1**

{note 1 on p. 281 reads: 1. As we will see, **it was used by Hjalmar Schacht in the 1930s** and is used frequently by developing countries. I have recommended this to the Japanese government for years. See, for instance, Werner (1994b, 1998b, 2000a, 2002d, Appendix}

The more obvious and better-known mechanism is the one prescribed even by introductory economics textbooks: **The central bank can inject money directly into the economy, even when banks are bankrupt, by increasing its purchases of assets, including government bonds**.2 Yet the central bank has denied the truth of this fact for years - out of incompetence? The deeper I researched into the issues and their history, the clearer it became that the leaders at the Bank of Japan have personally been very familiar with Japan's predicament and how to end it. In several previous recessions that were due to a credit crunch (such as the 1960s slump), the central bank increased lending to the corporate sector and the government. Also today, the **central bank has many options** available to achieve this. To name a few, it could **purchase debt paper issued by firms, lend to the government, buy more bonds**, buy real estate and turn it into public parks, **or just print money and hand some to each citizen**. In all cases, purchasing power would increase and demand would be stimulated. **Printing money might also weaken the yen, which would help exports**.3 This would not produce inflation, since the very problem and cause of the recession is lack of money and hence deflation.

An economic recovery could have been engineered at any time during the 1990s by increased central bank credit creation. Japan could have had high growth throughout the 1990s if the Bank of Japan had wished it to happen.

All this is not rocket science. Moreover, today central bankers can look back on the rich history and experience of the Bank of Japan or other central banks that have dealt with the same issues, such as the German central bank or the U.S. Federal Reserve. So the puzzle remains: Why did the Bank of Japan not create more money?

{p. xiii} Concerning the motives of the players, there is little doubt that over the 1990s, the Ministry of Finance, just as the many governments that came and went, had every incentive to create an economic recovery. The ministry, in the firing line of fierce criticism, was painfully aware that a long recession endangered its legal predominance and that of the postwar economic structure. Upon closer examination, the motives of the central bank seem less clear.

By 1992, **when I was a visiting researcher at the Bank of Japan, I had discovered the importance of credit creation and its allocation**. I realized that Japan's recession was going to get worse and unemployment was going to soar if the central bank did not implement the right policies. Interest rate reductions and fiscal policy were not sufficient. What was needed was more central bank money creation. But at the time the central bank was doing the opposite, actively withdrawing money from the economy. I could not understand why and kept asking different members of the Bank of Japan to give me an answer. Finally, one particular central banker explained to me: **"If we printed more money, we would get a recovery. But then nothing would change. Japan's structural problems would not be solved."** At the time I could not believe his words. Would the Japanese central bank intentionally prolong the recession in order to change the economic structure? Would it be the job of the central bank to implement such economic and social change - especially change of such scale, at such economic and human cost, and in this opaque fashion? By 1998 **suicides had reached a postwar high**, many induced by the recession.4

The Bank of Japan's official statements about its policy have been highly contradictory. On one hand, the central bank has insisted that the recession was due not to its policies but to the economic structure. That's why structural changes, not monetary stimulation, were necessary - as its officers never tire of repeating. Yet its staff (including its governor) have also said that **they did not want to stimulate the economy** (thus admitting that they could), **because this would put off "badly needed" structural changes**.5 Central bank staff even argue that significant monetary easing "could cause harm" by inducing "a further delay in the progress of structural adjustment."6 Adam Posen, an economist at Washington's Institute for International Economics, has therefore concluded: "Between a process of elimination, and careful reading of the statements of BoJ policy board members, I am led to the conclusion that a desire to promote structural change in the Japanese economy is a primary motivation for the Bank's passive-aggressive acceptance of deflation."7 If the reader is as skeptical as I was in the early 1990s, then this is a conclusion that is hard to accept.

The Rise and Rise of the Bank of Japan

If a recovery would prevent structural changes, then this means that structural changes are not necessary for a recovery. So why are structural changes needed? While the Japanese system has had many problems and there is room for improve-

{p. xiv} ment - especially when it comes to increasing the **quality of life, the size of houses, leisure time available, the number of parks**, and so on - it is not clear that a U.S.style economic system will significantly improve living standards. A U.S.-style economic system also has disadvantages. The Japanese economic system had many positive aspects that could have been preserved if a public debate had occurred about the structural change agenda.

The fact is that the recession of the 1990s has indeed triggered a structural transformation that many experts refer to as "remarkable."8 The structural and administrative reforms of the 1990s did not just create losers. While former Okurasho {MoF} bureaucrats may have been close to tears on New Year's Eve 2000, the champagne corks were perhaps popping elsewhere. When the Okurasho {MoF} was scrapped, its tasks had already been either abolished or reassined to other agencies. **In 1998 monetary policy was put into the hands of the newly independent Bank of Japan** and **regulation of the financial sector was put into the hands of the independent Financial Services Agency (FSA)**. Since many of the influential FSA staff hailed from the central bank, a clear winner had emerged from the administrative reshuffling.9 That was none other than **the Bank of Japan, MoF's long-standing rival. It had finally triumphed** and was now more powerful than ever before.

Despite the ministry's dominant legal status, the central bank had the better cards: It was **in charge of a little-known and extralegal credit control mechanism**. Hiding behind the smoke screen of traditional interest rate policies, its decision makers remained entirely unaccountable. All this was possible because of a lack of transparency and a lack of meaningful accountability by the central bank for its monetary policy.

Central Bank Independence

The new Bank of Japan Law was proposed in 1997 as part of Prime Minister Hashimoto's administrative reform program. At the time, the financial press argued that the new law merely meant **a "slight increase in autonomy" for the Bank of Japan**. 10 The deputy governor of the Bank of Japan at the time, Toshihiko Fukui, lobbied press and politicians and argued that the new Bank of Japan Law "would allow the bank to make monetary decisions faster and more flexibly, and help it gain more credibility from the financial markets."11

This is not what happened - just as I had feared in 1997, when the new law was being debated. By that time I had done enough research to become convinced that the **new BoJ Law was against the interests of the Japanese people**, and by example also **a threat to democracies** in other countries. So I did my best to stop its passage. I faxed a letter to as many parliamentarians as I could. I also tried to arrange meetings with the members of the relevant parliamentary committees. Many ignored my faxes and phone calls. But a substantial number did take the time to see me and hear what I had to tell them. But it was an uphill

{p. xv} battle. Just as I had thought myself before my years of research on the Bank of Japan, **most experts** also **felt that central bank independence was a good thing**. We will see later in this book that **the arguments in favor of central bank independence, whether in Europe or Asia, have serious flaws**. This includes the argument that the German Bundesbank's great success was based on its independence. The truth, as we shall see, was quite the opposite.

The **new Bank of Japan Law was passed. And that is why today the government has no more control over monetary policy**. After the stock market falls of 2001 and 2002, many politicians called for the resignation of the BoJ governor. Mr. Hayami responded to such criticism by demanding that Japanese people **give up lifetime employment and face less job security**. His own job security was assured. There was nothing the government could do to sack him. Under the new Bank of Japan Law he was not doing anything wrong, because it does not clearly state that it is the job of the central bank to achieve healthy economic growth.

There is no mechanism for politicians to exert their will, except **changing the central bank law again**. It is not the government but the BoJ that decides whether we will have a boom or a recession.

Just Who Are the Central Bankers?

While the central bankers are good at keeping a low profile, their career paths tend to be more predictable than those of ordinary citizens or politicians. Few people would venture to guess who the next finance minister is going to be or how long the current prime minister will last. During the postwar era there has been no such uncertainty about the top job at the Bank of Japan.

Japan has had twenty-six prime ministers in the fifty-eight years since the war. However, a much smaller number of people have been in control of Japan's money and hence the heart of its economy. **Known as "princes" by their colleagues, they were the men behind the Bank of Japan**. Like the puppeteers of Japanese bunraku. dressed in black and moving in the background, these little-known central bankers shaped key events in Japan's postwar history. Politicians, governments, and bureaucrats - even the mighty Ministry of Finance - became unwitting puppets in their money game. Yet until now very little has been known about them and their policy tools. I hope this book will shed some light on their activities and make the reader more aware of the power wielded by unelected central bankers.

Even today, a large number of journalists and commentators seem quite sure about who is going to be the next Bank of Japan governor. In May 2001, in the same week this book was published in Japanese, Toshihiko Fukui, head of the Fujitsu Research Institute, staged an attempt to take over from Governor Hayami as the new governor. The media had been touting Fukui as an "impressive" candidate, the leading contender "in the running for the BoJ governorship," and "in line for the top job."l' The Nikkei, Japan's leading financial newspaper, prematurely introduced him on its cover page, with a photo, as the new governor. In

{p. xvi} the event, Governor Hayami refused to resign. However, his five-year term ends in March 2003. Until December last year, despite other plausible candidates, the media agreed on the likeliest successor: Toshihiko Fukui, called the "compromise candidate at the top of the list" by the Financial Times. Why? He is an "effective leader, capable of steering the BoJ through the murky waters that lie ahead."13

In actual fact, in postwar history there has been little compromise in the selection of the true heads of the Bank of Japan. The same unanimous case was made by the media and well-informed observers before Yasushi Mieno became governor in 1989, and ten years before that, when Haruo Maekawa became governor. Again, ten years earlier, the insiders knew that Tadashi Sasaki would become governor. We find in this book that Fukui, Mieno, Maekawa, and Sasaki have many things in common. The least of those is that they were at the helm of the central bank for ten years each, and they all played a leading role in the Japan Association of Corporate Executives (Keizai Doyukai), which has argued since the 1970s that Japan should radically change its economic structure. More ominously, all of them had been known as "princes" since their youthful early years at the central bank - the anointed future heads of the Bank of Japan. It was an epithet that was not awarded lightly: only one central banker per decade could become a prince.

In its earlier Japanese version this book contributed to an increasing awareness by the Japanese public about these princes, their goals and their way of implementing their policies - including Fukui's pivotal role in the events that led to the creation of the financial bubble of the 1980s and the decade-long period of underperformance in the 1990s. Moreover, more politicians appear to understand that the Bank of Japan has been the main culprit behind the Japanese malaise and that a more supportive policy by the central bank is a necessary condition for an economic recovery. Perhaps as a result, Prime Minister Koizumi stated in late December 2002 that he would appoint as governor of the Bank of Japan only someone who is "aggressive in fighting deflation."14 This should effectively have ruled out "prince" Fukui as contender: not only his past actions but also his recent statements seemed to indicate that he is unwilling to fight deflation.15 To the contrary, he demanded that more companies should be bankrupted and that Japan's unemployment rate should rise further to at least 8 percent.16 But what is said is not always what is done.

If an outsider had been appointed as new Bank of Japan governor, in place of Fukui, the old guard at the Bank of Japan would likely have resorted to a welltried method of staying in charge in such cases: we will see in this book that whenever a former Finance Ministry official or an outsider from the private sector became Bank of Japan governor, he would be kept in the dark about the - allegedly "technical" - details of **the actual monetary policy implementation, namely the quantity of the central bank's credit creation**. These were decided by the deputy governor, one of the princes, who would after five years become official governor.

During the first five years, the official governor would have control over the

{p. xvii} minor policy tools of interest rates and banks' reserves with the central bank, while the old guard would remain in charge through their control over the quantity of credit.

In the event, Toshihiko Fukui once again made the race, just as had been planned thirty-five years ago. Back in 2000, when I was finishing the Japanese version of this book, I predicted that he woud become the next governor of the Bank of Japan. The fact that he was duly appointed, despite contrary statements by the prime minister and by an administration famous for surprise appointments, merely serves to demonstrate the extent of the power wielded by the princes.

Public Debate Is Needed

Nobody knows better than prince Fukui that the introduction of an inflation target, now thought to be favored by the prime minister, is also not itself a solution. He knows that what is needed are policies to expand credit creation. Instead, just like the Reichsbank during the Weimar Republic, the Bank of Japan has been implementing inappropriate credit policies that go significantly beyond the call of duty without the necessary accountability. There is a danger that the European Central Bank and the U.S. Federal Reserve are following in the footsteps of these central banks.

Even central bankers are human. As such, they are as prone to errors and acts of selfishness as anyone else. What they need is the right incentive structure to limit these tendencies, namely, democratic checks and balances. Implementing such checks does not mean that money should be debauched and inflation allowed. To the contrary, history teaches that the only guarantor of stable money is accountability of a centrJ bank that has been given the right policy goals.

A broader debate about the correct role of central banks in democracies is necessary. Any such debate must be based on knowledge of the facts and the history of central banking. This includes the realization that central banks often may use interest rates as a smoke screen to distract others from their true policies, which usually can be judged better when measuring the quantity of credit.

I am happy to report that my book has made a modest contribution to this effort. The Japanese version was published with a print run of 150,000 copies, becoming a number one best-seller. Many members of parliament read it. Several LDP members took it to heart and established the LDP Central Bank Reform Research Group. I hope the English edition will contribute to the stimulation of such debate also in other countries.

Tokyo, 28 February 2003

Richard A. Werner

{p. xviii} Acknowledgments

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agement, guidance, and advice of many people, without whom this book would not have been completed. ... Kenneth Courtis, ... Eammon Fingleton, ... Chalmers Johnson, ... Karel van Wolferen, ... the friendly staff of the former Japan Development Bank, the helpful staff I met at the Nomura Research Institute, the many honest staff of the Bank of Japan (and who had best remain unnamed), the members of the Ministry of Finance's research institute; ...

{p. xx} Note on the Representation of Personal Names: The ordering of first names and surnames follows the conventions of the English language.

{p. 1} Japanese Lesson

New Era Dawning in Japan

Fundamental changes in Japan's economic, social, and political system have happened only twice in modern Japanese history: during the Meiji period, in the late nineteenth century, and during war and defeat sixty years ago. In both cases, crises triggered the change. The threat of colonization by foreign countries propelled the Meiji reforms. The Great Depression, the Pacific War, and consequent defeat were the triggers for the second major mutation.

The postwar miracle of high growth was, despite all its achievements, largely a quantitative change, one that took place within the unchanged economic and political institutions that had earlier been put into place. Today, Japan is once again at a crossroads. **The crisis of the 1990s** has spelled the **end of the "Japanese-style" economic system** as we know it. **Japan is now** in the process of **switching to** a fundamentally different form of economic organization, namely, **a U.S.-style free market economy**.

Back to the Future - Forward to the Past

The irony is that **this system is not new for Japan.** Few people are aware of the fact that **free markets were almost the norm in Japan before the war**. In the 1920s, the famous postwar Japanese system did not exist. Then, Japan's economy in many ways looked like a carbon copy of today's U.S. economy - with fierce competition, aggressive hiring and firing, takeover battles between large companies, few bureaucratic controls, strong shareholders that demanded high dividends, and corporate funding from the markets, not banks. Yet throughout the postwar era, Japan's economy has been the opposite: highly regulated, with cartels limiting competition, bank financing and cross shareholdings reducing shareholder power, no takeovers, and a frozen labor market with lifetime employment and seniority pay.

The peculiar nature of this postwar economic system has puzzled observers for decades. Leading economic theories indicate that **only free markets can lead to success. But Japan rose within decades from developed-country status to become the second largest economy** in the world without relying only on the "invisible hand" of free markets. Many theories have been advanced to explain this enigma.

{p. 2} War Economy

What changed Japan was an event that is often neglected in research on Japan, one that took place between the prewar era and the postwar era: the war itself. **The Japanese economic system was created largely during World War II.** Its true nature is that of an output-maximizing **mobilized war economy.**

Japanese corporations have been on a war footing since the early 1940s. In the early postwar era, the United States was keen to demonstrate to the world that post-occupation Japan had been reshaped in its image. In reality, with the beginning of the Cold War, **the United States decided to maintain Japan's war footing and keep its wartime bureaucratic elite in power.**

While Germany's minister of the war economy, **Albert Speer, remained in Spandau Prison** as a war criminal, **his Japanese wartime colleague became prime minister** and, together with his brother, **governed Japan for twelve crucial years**. During this period, **from the late fifties to the early seventies, the wartime bureaucratic elite, still at the control levers**, managed to **complete the** system of the **"total economy" that had delivered rapid resource mobilization during the war years**. Capable of servicing a far larger market than the restricted domestic economy, it had to expand overseas. The United States, interested in strengthening Japan, allowed this to happen. It was the system of a mobilized war economy that spearheaded Japan's postwar **conquest of world markets**.

The main reason why the extraordinary nature of Japan's system has remained unknown for so long is the ahistoric and usually counterfactual approach of many current economic theories. **History provides the data set for the scientific economist to study. Ignoring history means neglecting the facts.**

Big business and politicians also had a role to play in Japan's miracle model, but in the end the economy was controlled not by the triangle of business, politicians, and bureaucrats but by the much narrower triangle of the Ministry of Finance (MoF), the Ministry of International Trade and Industry (MITI), and the Bank of Japan (BoJ). Among these three institutions, the Bank of Japan has had the lowest profile. There was a reason why it was so self-effacing. Although its technical knowledge of the most powerful control tool ensured that in practice the central bank ruled Japan, it was legally subordmate to MoF. Therefore it has always pretended to have very little power. This book tells the story of the true extent of the use and misuse of its power.

Government Intervention Can Create Fast Growth

Economic success and free market economics are virtually synonymous in the eyes of many opinion makers today. This is why developing countries are persuaded to adopt the mantra of the World Bank and the IMF - liberalization, privatization, and deregulation - to achieve economic development. When the Iron Curtain fell and many communist countries adopted market-oriented economic systems, some ob-

{p. 3} servers even argued that the "end of history" had arrived: The struggle between rival economic systems was over, and the free market system had won.

However, Japan did not use free markets to become the second largest economy in the world. This means that **there is a rival capitalist economic system, based on the very visible hand of planners, that has outperformed other systems** in terms of economic growth rates over a sustained period of time.

The Japanese experience also teaches that **government intervention** has been misunderstood so far, for it **did not take the form of meddling micromanagement, as in a planned economy**. Instead, Japan's wartime government officials primarily intervened visibly by conscious institutional design that was aimed at **creating the right incentive structures** for fast growth. Successful government intervention is about organizational design, not picking winners.

Institutional Design

Influenced by German thinkers, the war economy leaders encouraged the creation of large-scale firms. They realized that among the three stakeholders involved in large companies - management, shareholders, and employees - **shareholders' aims were least in line with the planners'** overall goal of fast growth. So **shareholders were eliminated, managers elevated**, and employees motivated through company unions and job security.

Management, freed by cross shareholdings from dividend-oriented shareholders, did not pay out profits but reinvested them. This allowed them to grow their companies and expand market share. It biased Japan's economy toward high growth.

At home, the ensuing cutthroat competition for market share **had to be contained by the formation of cartels**. This did not mean that competition ended; companies continued to compete to keep up their rankings within the cartel. Most importantly, there were no cartels restricting competition abroad. The world's open doors and free markets meant that Japan's growth machines wreaked havoc. In the 1960s and 1970s, **one leading U.S. industry after another was eliminated**. **Europeans**, less dogmatic about free trade, s**imply restricted Japanese entry**. The Japanese complied - managed trade was what they were used to and trade friction never became a major issue with Europe.

The High Price of Success

The war economy system was highly successful in achieving its goal of rapid economic growth. But there was a price to pay. **Worker benefits were usurped by the small minority employed by the large firms**. About two-thirds of all employees still work for small firms, where they never enjoyed the lifetime employment, housing and welfare support, and big expense accounts that large firms offered. A number of **mechanisms forced** the majority of **the workforce to underconsume and save** much of their hard-earned income. These included **tax incentives, high costs**

{p. 4} **for** necessities such as **food and education, high and rising land prices, and a patchy pension system.**

In the race for a higher ranking in the world, goals such as quality of life and the environment, as well as individual freedom and choice, were judged lower priorities. Living conditions in Japan are still relatively poor or at least not commensurate with the country's status as the world's number two economic power. Houses are small, **commuting in crowded trains often takes two hours or more, and leisure time is limited**. Concentration in a few urban areas and conformity even of leisure patterns limit the quality of holidays.

At the same time, the Japanese system delivered great income and wealth equality and hence social cohesion, stability, and peace. Japan's low crime rate is still the envy of the world. Many developing countries would accept such a price for success. The implication for them, as well as for economies changing from a noncapitalist system to a capitalist one, is that they can potentially do much better by adopting the Japanese mobilized economy model than by simply introducing free markets and waiting for the invisible hand to deliver growth. Which economic and social system is preferable - free markets or the mobilized economy - is a political decision. It should be treated as such.

The implication for Japan is that its system is not immutable. It does not go back over two thousand years. The postwar system of the war economy was introduced barely sixty years ago. This proves that Japan is capable of dramatic change. All we need is a crisis - a shock that is large enough to trigger the change.

Hitler's Control Tool

While most of the intervention in Japan's economy took an indirect, market-oriented form, there was a control tool that was used for powerful direct intervention. However, it works in such a subtle way that today many economists would still dispute its presence. The tool is money. **The wartime bureaucrats understood** what **money** is, where it comes from, and how it could be used to control every aspect of the economy.

In Europe, the evolution of monetary economics was hampered by the backwardness of its economic system. **While the Chinese emperors had already invented paper money and used it to totally control their empire in the tenth century A.D., European rulers still believed that only precious metals could be money**. As a result, they were not in charge of the money supply, and hence also not in control of their countries. **Gold proved cumbersome to deal with, so it was deposited with goldsmiths, who became the first bankers**. A mistaken understanding of their activity led generations of politicians and economists astray as they ignored the farreaching implications of the fact that **banks create money and decide who gets it**. This also explains why the levers that have been manipulating the Japanese economy remain largely unknown. The war bureaucrats, on the other hand, understood the role of banks and recognized that money is the lifeblood of an economy.

{p. 5} **Influenced by the methods of Hitler's central banker, Hjalmar Schacht, the leaders of the Japanese war economy** turned credit creation into their most powerful mechanism for total control. They used the banking system purposely and skillfully to allocate resources to targeted industries.

Window Guidance

The credit controls used by the war bureaucrats survived virtually unchanged into the postwar era. They took the form of the **extralegal and secretive "window guidance"** operated by the Bank of Japan. This "guidance" consisted of **direct credit allocation quotas strictly enforced by the central bank**. It was **at the core of Japan's postwar economic success**. It also explains the success of **Korea and Taiwan**, where **the Japanese installed the same during the war,** and **where the postwar leaders continued to use it.**

In the 1950s and 1960s, window guidance controls became instrumental in the emerging struggle for supremacy between the powerful Ministry of Finance and the legally subordinated Bank of Japan. While the ministry won the first political battle and avoided a change in the **Bank of Japan Law** (which had been introduced in **1942, largely as a translation of Hitler's Reichsbank Law of 1939)**, the Bank of Japan remained solely in charge of window guidance. It lulled the ministry into a false sense of security by allowing it control over interest rates and downplaying the importance of quantitative credit policies. A string of Bank of Japan studies, supported by conventional neoclassical economics (which at best sees no role for credit policy and at worst simply assumes money does not exist), "proved" that credit controls were ineffective. Thus the Bank of Japan announced that they were abolished. Memories of the powerful nature of the controls faded over the years. By the 1970s, few observers were aware of the fact that while the Finance Ministry might reign, it was the Bank of Japan that ruled.

Test Run: The First Bubble

In the 1970s, the Bank of Japan flexed its credit control muscles to test the limits of its autonomy over running the economy. **Using window guidance, it ordered the banks to expand credit to speculative real estate borrowers**. As a result, land prices soared and Japan found itself in the midst of the first postwar bubble economy. The recession that inevitably followed shook the established elite, foremost the Ministry of Finance. The role of window guidance credit controls remained little known, so virtually no blame fell on the Bank of Japan.

This experience laid the groundwork for the events of the 1980s and 1990s. It emboldened the **central bank to develop its own plans for a new economic, social, and political system for Japan to replace the war economy**. The new system was **modeled on U.S.-style free markets**. The Bank of Japan preferred to **move "back to the future" of Japan's free market past**, where **shareholders were in charge**, not

{p. 6} other stakeholders, such as employees. Equally importantly, **a free market system often leaves the central bank as the uncontested authority** over the economy. Of course, to introduce such deep structural changes, the entire war economy system had to be dismantled. That amounted to a revolution. And revolutions happen only in times of crisis.

Buying up the World

From around 1986 until 1990, Japanese money flooded the world. From real estate in New York, Hawaii, and Australia to corporate takeovers in the United States, Europe, and Asia, **Japanese money seemed to buy up the planet**. The scale of overseas investments was unprecedented and its sheer size left the experts without explanations. **Japan was not just using up the dollars it had earned** through its sizable exports and trade surpluses; **in 1987, Japanese net long-term foreign investment** was almost **twice as large as the record-high current account surplus**. Foreign investment of that scale defied traditional economic models. Japanese money flows remained a mystery. The plot thickened in 1991, when Japan suddenly turned from being the biggest net capital exporter ever to a net importer of capital. What was the cause of these events?

Credit Bubble and Bust

During much of the late 1980s, Japan created too much money, and some of it spilled over abroad. Bank credit creation expanded at a rate of about 15 percent, while national income grew by only about 6 percent. The newly created money was not used productively. It **went into speculative purchases of land and stocks**. Enormous amounts of new purchasing power pushed asset prices to dizzying heights. In 1989, **the little plot of land surrounding the Imperial Palace** in Tokyo **had the same market value as the entire state of California**. It was a bubble.

In the long run, **credit creation that is not used productively cannot be paid back**. The excess credit creation beyond the needs of the economy had to turn into bad debts. This is what happened from 1990 onward. Bank loan growth slowed. As asset prices fell, **speculators were bankrupted** and banks were left holding the bag. About 100 trillion worth of **loans**, a fifth of

Japan's GDP, **turned into bad debts in the 1990s. Banks were paralyzed and stopped lending**. The credit crunch boosted unemployment. The economy moved into the worst recession since the Great Depression.

Who was to blame? Most observers believed the Ministry of Finance was in charge. The ministry also thought so. But all its attempts to create a recovery were to no avail. Despite record low interest rates and unprecedented spending packages, the economy failed to recover. Most observers concluded that the system did not seem to work anymore. The long recession of the 1990s took the shine away from Japan's postwar miracle and destroyed the consensus that had maintained the war economy.

{p. 7} But the system was not the reason why the economy went trom boom to bust. Nor could lowering interest rates or fiscal policy help. There was a simple policy that could easily have created a recovery as early as 1993 or 1994. Since **banks were not creating enough money, prices were falling, demand shrinking, unemployment rising**. The economy simply needed more money. Nothing could have been easier than that - **the Bank of Japan could just have switched on the printing presses.**

The Battle of the Yen

So just how much money did the Bank of Japan print in the 1990s? Very little. While the Ministry of Finance desperately tried to create a recovery, the Bank of Japan didn't seem in a hurry. **Although it lowered interest rates, as ordered by the ministry, it simultaneously reduced the amount of money in circulation**. Zero interest rates don't help if the majority of firms (small firms) can't borrow money at any rate. **When the ministry increased fiscal spending, the central bank failed to fund it with new money creation. So it was funded by bond issuance to private investors, which merely crowded out private demand**. In early 1995, when in desperation the ministry tried to boost exports through a weaker yen and thus ordered record amounts of foreign exchange intervention, **the central bank quietly sterilized all intervention**. The yen remained strong. In March 1995, the **central bank oversterilized** and so sent the yen to its postwar high of 79.75. This delivered another severe blow to the economy and the ministry.

No doubt, the recession of the 1990s was the result of the central bank's policies. It could fine-tune it through the quantity of credit. An analysis of its actions indicates that it chose to prolong it.

Meanwhile, the central bank launched a frontal assault on the power base of the ministry. For the first time since the 1960s, it reignited a public debate about the Bank of Japan Law and lobbied politicians for its cause. Its goal was to become legally independent. Since the ministry was blamed for the recession, the central bank won the battle. The ministry was defeated and stripped of all key power levers. The central bank is now independent and unaccountable. In Asia, defeated enemies often are at least allowed to save face. No such mercy for the ministry: To add insult to injury, it was stripped of its grand old name. In January 2001 the Okurasho ceased to exist.

The Strange Policies of the Central Bankers

Why did the Bank of Japan prolong the recession of the 1990s? A conclusive answer can be found only when another puzzle is solved. The events of the 1 990s are rooted in the bubble of the 1980s. How did the bubble, the greatest resource misallocation in peacetime history, come about in the first place'? We know that it was due to excessive credit creation by banks. But why did the banks lend so much'?

We know that from about 1940 until the end of the 1970s, bank lending was

{p. 8} determined by Bank of Japan window guidance. However, according to official statements by the Bank of Japan, these credit controls had been abolished and were not in use during the crucial 1980s. This is the accepted view to date. Is it true? The evidence is that window guidance continued. It is the smoking gun. Who pulled the trigger'? What were the motivations of the decision makers? The answer will provide clues to why the Bank of Japan prolonged the recession of the 1990s.

Japan's remarkable story is not without parallel. **In the early 1990s, the central banks of Korea, Thailand, and Indonesia embarked on the same policies as the Bank of Japan in the 1980s**. Using the extralegal "guidance" of bank lending pioneered by the Reichsbank in Germany, they forced their banks to lend excessively to real estate speculators. The bubble was further inflated by central bank policies to maintain an overvalued fixed exchange rate and higher domestic than foreign interest rates. **Speculators were given every incentive to borrow from abroad**. Record amounts of **U.S. dollars flooded the Asian region**, further fuelling the asset bubble and rendering the situation more precarious. I**n 1997, investors pulled out**. Simultaneously, the central banks forced the commercial banks to restrict credit creation. The bubbles burst.

Instead of quickly floating their currencies, the central banks ensured that their substantial **foreign exchange reserves were wasted in a futile attempt to defend the overvalued exchange rates**. By late 1997, all three countries were insolvent. As central banks reduced credit creation further, the crisis turned into recession. Why did they all take these same, disastrous policies?

The Second Economic Miracle Ahead

By the 1970s, more voices argued that Japan's wartime system would not deliver high growth anymore. The old system had maximized output by increasing inputs, such as land, labor, capital, and technology. But by the 1970s, Japan was running out of inputs, and hence the potential growth rate was declining. A similar story was told about other Asian countries in the 1990s. One proposed solution was to **boost productivity by introducing U.S.-style capitalism**.

Almost sixty years after its introduction and extremely successful performance, **the Japanese war economy structure was scrapped**. The historic deregulation, legal changes, and market-oriented reforms of the 1990s eroded its foundations. Market forces are now pushing ever faster toward the goal of U.S.-style markets. New industries were born of deregulation.

The domestic economy has become more productive and is now able to deliver up to 4 percent noninflationary growth. For an advanced economy such as Japan's, this is nothing short of a second economic miracle. So is all fine and well with Japan and its Asian neighbors? We will know only once we have answered all the puzzling questions.

{p. 9} 2 The Total War Economy

The Future Is in the Past

The defeat of 1945 is often regarded as a watershed that heralded the beginning of a new Japan. The dark past was left behind and a fresh start was made with new institutions and economic structures, set up from scratch under the guiding hand of the U.S. occupation. The pictures of burned-down cities, destroyed factories, and ruined bridges sometimes give the impression that a new era started in the ashes of August 1945 . The U.S. occupation, of ficially in charge until 1952 - longer than in Germany - implemented the U.S. program of reeducation and democratization of the Japanese people. It provided Japan with a new constitution, political parties, free elections also for women, and a market-oriented capitalist economic system. MacArthur's reforms allowed labor unions, broke up the aibatsu, and introduced sweeping land reforms.

Many books and especially popular accounts of Japan therefore start their analysis in 1945, and Japanese history is usually divided into the neat segments of postwar and prewar. Not all scholars look at it this way, as the division into postwar and prewar periods leaves out the most important period in Japanese history this century - wartime.1 For it is during the war that virtually all of the characteristics of the Japanese social, economic, and even political system of the postwar era, all that we call "typically Japanese," were formed.

Postwar sales drives and inroads int**o world markets by Japanese companies have often been likened to military campaigns. The employees of Japanese companies call themselves senshi (soldiers)**, and their well-known **lifestyle is comparable to that of troops in an army**. However, the characterization of Japan's postwar economic system as a war economy is not meant metaphorically; it is literally true. Japan's postwar economy is **a fully mobilized war economy, with production shifted from weapons to consumer products**.

Guess the Free Market Economy

The reader is asked to guess which country is described by the following facts. It is a country characterized by virtually unmitigated capitalism. The stock market is the main source of external funding tor companies in this country. Shareholders

{p. 3} are all-powerful and demand high dividends. This forces management to be oriented toward short-term profits. **Most managers are appointed from the outside, not from the ranks** of the company. Fierce takeover battles and corporate buyouts keep management on their toes. If they don't perform, they could be out of a job in no hme.

The labor market in this country is characterized by hiring and firing and **a high rate of job switching** by employees. Income and wealth differentials are large. A whole class of **rich capitalist families lives off their dividend income.** The overall savings rate is low and **consumption constitutes the biggest part of GDP - about 80 percent**. There are **few government regulations, and government officials exert little direct influence** over the economy. Indeed, bureaucrats have to do as politicians tell them. There are fierce disputes over policy issues and public interest in politics is high, at times even passionate.

It would be natural to identify the country in question as the present-day United States; the description fits that country fairly well. However, the country referred to is Japan - the **Japan of the early 1920s**. Many observers believe that the typical, "Japanese-style" economic system has been around since before this century and has its roots in age-old Japanese culture. But scholars have by now established as fact that, to the contrary, the Japanese-style economic system that we know hardly existed in the 1920s.

Japan in the 1920s: Hotbed of Free Market Capitalism

In the 1920s, in many ways Japan was a different country from the one we have known since the postwar era. Its economic system was not pure free market capitalism, but it was much closer to this ideal than it has been ever since.2 Neither lifetime employment, a seniority-based wage and bonus system, nor company unions were widespread. Firms had few scruples about rapid hiring and firing. Neither did employees have any qualms about quitting to seek greener pastures: Japanese employees changed jobs as much as U.S. employees do now (a figure three times as high as in the Japan of the 1980s). Unions were organized by trade, not by company, thus providing employees with a better voice to call for pay raises - something that became effectively impossible with the company union system of the postwar era. Influential labor unions organized many seriously disruptive strikes in the 1920s, something unheard of in postwar Japan. The unemployment rate was not 2 percent, as during much of the postwar era, but in the double digits.

Firms were not majority-owned by other companies, as in the postwar system of cross shareholding. In the 1920s, there were real capitalists, individuals and families, holding substantial portions of stock. Individual share ownership accounted for the large majority of all shareholdings, while by the early 1990s it had fallen to less than 15 percent. It was natural that the shareholders would be directly represented on the company board and have their voices heard in the determination of company policy. Before the war, the majority of directors on the boards of large

{p. 11} companies were outside appointees, put in place by the shareholders. **By contrast, in 1990, over 90 percent of directors** on the boards of large firms **were internal appointees, raised from the management of the firm**.

Back in the 1920s or 1930s, shareholders were powerful because companies obtained between 30 and 50 percent of their external **funding from the stock market**. In the postwar era, such as the 1960s and 1970s, fund-raising from the stock market accounted for merely 5 to 10 percent of total external fund-raising.5 The shareholders in the 1920s used their influence to demand high dividends. This required the tirms to pay out as much of the profits as possible.6

Going for Profits, Not Market Share

In the 1920s and early 1930s, more than two-thirds of profits among leading Japanese companies were paid out as dividends, a sizable 6 percent were paid out as directors' bonuses, and only 25 percent were kept as reserves.7 By contrast, in the period from 1966 to 1970, 43 percent of profits were paid out as dividends, only 2 percent as directors' bonuses, and a massive 55 percent was reinvested.8 In other words, **before the war the distribution of profits was heavily skewed in favor of the capitalist owners**. Dividends reflected the fortune of the firm and thus fluctuated with it (unlike the low, virtually fixed dividends of the postwar era).

If management did not implement the owners' orders, they would quickly be sacked and replaced by a new team. This was quite in contrast to postwar Japan, where annual general meetings were rubber-stamp affairs that approved management in a matter of minutes, without discussions or questions being raised (a reason why the sokaiya racketeers could make a living simply by threatening to ask questions at shareholders' meetings).9 **Today's *salarimen* consider the firm "their own," not the property of shareholders, and feel justified to run it as they see fit, without explanations to shareholders.**

While **in postwar Japan income and wealth were highly equalized**, in the 1920s there were significant disparities, with many affluent owners of real estate and stocks who lived off dividends and rents. An important part of this capitalist class were the families that owned the main zaibatsu through their control of the holding companies that concentrated shares. But there were others. Only ten of the sixty largest mining and manufacturing firms were related to the zaibatsu.10 The majority of firms were non-zaibatsu, and they had diffused share ownership.

The zaibatsu firms were keen to expand their influence, however. They aggressively bought up other firms in stock acquisitions and takeovers - a practice unheard of in most of the postwar era. Often **rival zaibatsu would engage each other in hostile takeover battles**. In the 1930s, the Mitsui group bought Meiji Sugar from the Mitsubishi group and two Toyo Sugar factories from the Suzuki group. Oji Paper took over management of Fuji Paper, although it was part of the competing Mitsui zaibatsu.

The contrast between prewar and postwar Japan is also reflected in savings

{p. 12} rates and the consumption share of GDP. **While consumption today makes up less than 60 percent of GDP, in the 1920s it accounted for about 80 percent - as much as in the United States today.** Likewise, the percentage of income that is saved, currently running at about 20 percent, was only about 5 percent before the war. Strong consumption sucked in many **imports of final consumption goods**, which was not the case in the postwar decades.

The reform bureaucrats of the 1930s criticized Japan for looking just like "the stereotyped view of American firms in the present time." 11 Had U.S. trade negotiators been transported from the

1980s to the 1920s, they would not have demanded that Japan change to become more like the United States, for it resembled modern-day U.S.-style capitalism.

The Crisis That Changed Japan

Japanese-style capitalism does not go back to Japan's mystical past and peculiar Asian values. Compared to the well-known postwar version, it barely existed in embryonic form in the prewar era. But **when and how was Japan so fundamentally transformed** from a fairly free market economy to the highly regulated postwar system? The answer must be found in the event that happened between the prewar and postwar eras: **the war itself.**

History teaches that no country changes fundamentally without a crisis. The 1930s and early 1940s were such a period. Until the early 1930s the paradigm that had prevailed outside communist countries was that of liberal free market capitalism without much government interference. In Japan there had been a strong tradition of government intervention, but by the early 1920s the arguments of free market capitalism had become influential. **There was also considerable external pressure from the United States for Japan to liberalize**.12 However, **in the 1930s, the intellectual tide in Japan was changing back to the idea of government intervention**, because the free market system did not seem to deliver: The fallout from the New York stock market crash of 1929 was borderless. Worldwide, distressed banks withdrew their loans, bankrupting large proportions of the corporate sector and choking off demand, which led to deflation and large-scale unemployment.13 This cast doubt on the capitalist paradigm. Quite apparently, free markets, left to their own devices, could also produce major economic disasters.

As economies shrank (13 percent in the United States, 23 percent in the United Kingdom,14 12 percent in Germany, and 9.6 percent in Japan),15 poverty became widespread. 16 The scale of deprivation is hard to imagine today. **Starvation and selling of children into prostitution** occurred in the United States, Germany, and Japan. A countrywide survey conducted by the military in Japan in the early 1930s found that a high percentage of young men were physically unfit for military service due to **malnutrition, disease, and job-induced disabilities**. Meanwhile, the capitalist "fat cats" continued to live in style. The Japanese elite saw that both military capability and the workforce would be severely affected if nothing was done.

{p. 13} Not fully comprehending the causes of the Great Depression, more and more thinkers and policymakers concluded that the capitalist system itself was at fault. Sitting idly on one's hands, as free market orthodoxy prescribed, was getting increasingly risky. It was the stuff revolutions were made of. The Bolshevik takeover of 1917, facilitated by dire economic straits and public discontent, was still fresh in everybody's memory.

Internal and External Threats

In Japan, the ruling elite and the bureaucracy became more worried about the possibility of a communist revolution. At the same time, a crisis loomed outside Japan's borders: As the Great Depression spread, countries engaged in competitive devaluation and trade wars to increase demand and income at home. As a result, prices were driven down further, heightening deflation. So more and more countries began to close themselves off from free trade, introducing quotas and tariffs. This was potentially disastrous, for, as a country with hardly any raw material resources, Japan had trade as its lifeblood. If it was not self-sufficient in food, it could survive only if it imported raw materials, processed them, and sold the value-added products abroad.

Japan's economy was crucially dependent on energy imports, mainly of coal and oil. These came largely across the Pacific from the United States. However, the United States had begun to turn protectionist and was fending off Japanese exports. It also increasingly disapproved of Japan's colonial ambitions in Asia.

The Quest for Autarky

Japan ignored U.S. critique. After all, the United Kingdom and the United States had so far been the colonial aggressors in Asia (together with France and Holland). Japan's leaders, especially in the army, had examined closely **how Germany was starved of raw material and food imports during the trade blockade of World War I.** They concluded that **as long as Japan was dependent on imports from the white man, it was not free**. With the internal threats of recession, unemployment, and communist takeover and the external threat of being cut off from world trade, the military concluded that Japan could survive in such a hostile world only if it was strong and free from blackmail. That meant **a strong and autarkic economy**.17

Externally, the military began to implement the dream of **"Asia for the Asians."** When they advanced beyond Manchuria into China in their quest for autarky, indications that the United States might play the trade boycott card merely confirmed their suspicions, and they accelerated the implementation of their plans.

Internally, they worked on dismantling the system of classical laissez-faire economics, which Japan had tried but found wanting. It was time to try something else. Military thinkers and reform-minded bureaucrats in Japan noticed that **economists in Germany were offering a different prescription. Under the Nazi adminis-**

{p. 14} **tration their counsel bore fruit**. Indeed, to quote British economist Joan Robinson. **"Hitler had already found how to cure unemployment before 'had finished explaining why it occurred."**18 Moreover, Japanese bureaucrats noticed that **one major country had escaped the Great Depression altogether: the Soviet Union**. In the 1930s, it embarked on a frantic government-led industrialization drive that was admired in many capitalist countries.

Reform Bureaucrats Pushed for a New System

In Japan, **the move away from the free market economy was spearheaded by the military and the "reform bureaucrats" who had entered** the ministries **during** times of **high unemployment and had** often **witnessed starvation** in the countryside. They were sympathetic to the critique by Japanese thinkers, such as Kamekichi Takahashi, and German economists, who censured the free market system for allowing rich shareholders to pursue profits while unemployment was endemic.19 The capitalist shareholders often squeezed firms just to raise their dividends. As funds were drained, firms had little to reinvest. Managers were thus often unable to act in the interest of longer-term profitability and survival. Meanwhile, large-scale stockowners often engaged in speculation, driving up share prices and then dumping the stocks for the capital gain, rendering the stock market little more than a rigged casino.

To the military, the equation was simple: To be strong, Japan's economy needed to grow fast. To increase growth, all resources had to be mobilized, ending the waste of unemployment. The reform bureaucrats also did not want to wait for Adam Smith's "invisible hand." They felt it had to be their quite visible hands that would strengthen Japan's economy. They urged government controls - thus they were often also called "control bureaucrats."

Their desire for controls **did not** imply **micromanagement as in a Soviet-style planned economy.** Their ideas were strongly influenced by anticapitalist and especially **national socialist thought from Germany**, which placed emphasis on **government intervention in the form of redesigning the incentive structures**.20 Thus it happened that by the early 1930s Japan had already started to embark on a mobilized war economy. The reformers met resistance on the way, so what we describe as the mobilized war economy was completed only toward the end of the war or even, in many ways, during the early postwar period.21

When hostilities with China turned into full-scale war in 1937, the military pushed through major changes under the cover of emergency war legislation, which gave the reform bureaucrats the mandate to establish a mobilized economy with strong government intervention. A new economic, industrial, social, and political structure began to emerge. When the hostilities turned into world war, even stronger legislation was used to completely reshape the Japanese economic, social, and political system. The redesigned institutional setup was to ensure that **managers and employees would work toward greater output, not for the sake of short-term profits.** It was a transformation that **created the postwar Japanese miracle economy.**

{p. 15} The Militarization of Japan

In 1936, the Hirota cabinet agreed to put the economy on a quasi-war footing. The first step was to boost the budget for military expenditure. As companies in the munitions sector watched the formation of the 1937 budget, they realized that substantial amounts of raw material imports were required to increase military production. A speculative import boom of raw materials ensued, throwing the balance of payments into sizable deficit. The **1932 foreign exchange control laws were used to restrict imports**. They had represented the first set of reforms that would eventually create a controlled war economy.22

The 1937 promilitary cabinet of Konoe (the grandfather of 1993 prime minister Hosokawa) promulgated three wartime control laws. The Export-Import Commodities Emergency Measures Law ordered **priority allocation of critical materials** to the munitions industry. The Emergency Capital Allocation Law controlled the establishment of companies, capital increases, dividend payments, bond flotations, and borrowing of funds. It was used to **channel money** to the munitions industry according to priority. The Munitions Industrial Mobilization Law furnished bureaucrats with further powers of control.

In April 1938, the sweeping National General Mobilization Law was put to the Diet. It allowed the mobilization of all physical things in the country, and it stated that "the Government may in time of war (including incidents that are to be treated as war) draft Imperial subjects and employ them in mobilization work as stipulated by Imperial Decree whenever necessary." It was pushed through by Konoe against vigorous resistance from politicians and business leaders, who realized it was a carte blanche - it did not specify the particulars of controls.23 The principle of **a general law that leaves the details to be filled in later by ministerial ordinances** gave all authority to the government bureaucracy that could freely wield it as it saw fit. The law gave the government the power to **determine prices, establish controls over production, distribution, consumption**, movement of goods, and foreign trade and to set up control agencies to implement the decrees.24

System for Maximum Production

With such legal powers in their hands and with the approach of Japan's entry into World War II, the Konoe cabinet in 1940 proclaimed the **New Economic Order, composed of a New Financial System, a New Fiscal Policy, and a New Labor System**. Overall coordination lay in the hands of the Cabinet Planning Board, set up in October 1937. It was designed as the economic general staff of the militarized economy. Its job was to set up a new economic system that would deliver maximum economic growth and to direct resources toward the priority industries.

The aim of the structural transformation was to develop an institutional framework that changed incentives such that everybody would be striving toward the goal of maximum output growth. Economic growth is achieved when some re-

{p. 16} sources are saved and invested. The more is invested, the faster the economy will grow and the greater national income will become. **A farmer starting out with nothing but a bag of rice seeds faces the choice between saving and consuming**. If he maximizes current consumption, he can have a feast this year, but will starve the next. The more he saves and replants (invests), the greater the crop in the future, as each plant delivers more than one hundred grains of rice. The more he consumes, the less is left for replanting.

Firms are the farmers of the economy. They face the decision whether to save and reinvest their profits or to pay them out to the shareholders as dividends. The smaller the dividends and the more money reinvested, the faster the company will grow. To create an economy that grows rapidly, the institutions of the economy must be shaped such that individuals will save and firms will retain earnings and reinvest.

Separation of Ownership from Control

There are three parties involved in the organization of firms: the owners, the managers, and the employees. In small, family-owned firms, all three roles may be played by the same person. This is what **classical and neoclassical economics assumes**, for its models consist of **many small firms, run and owned by one individual**. However, the rise of the large-scale corporation has driven a wedge between the three functions. Usually, large firms cannot be funded, hence owned, by one individual; they cannot be managed by one individual, and they employ a large number of workers.

So the rise of **the large corporation produced a separation of ownership from control** and the detachment of employees from the goals of the firms. Each group has different aims and incentives. In a one-man firm, all the incentives of the three different functions coincide and the firm is pulling in the same direction. However, in large firms, as the three groups become separate units, **each is striving for what is best from their viewpoint** and the firm begins to pull in different directions. The final outcome may not be what produces fastest economic growth. It may also not be what is best for society and the country.

Shareholders Versus Growth

The goal of the shareholders is profit maximization. If they are mainly interested in high dividend payments, companies may be starved of funds to reinvest and hence may grow more slowly. This tends to create surplus funds that a small class of rich owners spend on more trivial pursuits than productive investment. Income inequality rises, speculation and production of wasteful goods increases. Economic growth slows. For the super-rich, consumption is a small percentage of their total income and wealth.25 With high income and wealth inequality, consumption will be weaker than in an economy with an egalitarian distribution.

If employees are not motivated to work hard, and if they squeeze higher wages

{p. 17} and shorter working hours out of firms, it will also dampen profits and - if an economy-wide phenomenon - lower overall economic growth. So the reform bureaucrats concluded that **giving too much power to either shareholders or employees was bad** for growth.

They found the story different for managers. Managers receive not only higher pay but also greater prestige and power over corporate resources (including expense budgets) if they move up the hierarchy. Since the hierarchy is pyramidshaped, with fewer people at the top, more at the bottom, more managers will be able to rise up the ranks if the firm grows. So **the pursuit of their own goals leads managers to strive for faster growth of the firm**. While the aims of shareholders and workers are not directly in line with fast overall economic growth, the goals of the managers are.26

Capitalism Without Capitalists

The New Economic System aimed at setting the firm "free from control of stockholders pursuing profit making."27 Disempowering shareholders and workers while empowering managers would boost growth, the war planners concluded in the 1930s. The managers of large-scale firms were their allies, shareholders and unruly unionized workers their enemy.28 **Workers, though, could be won over if treated the right way**. To curb worker discontent and communist agitators, employees had to identify closely with the firm - for instance, by having a greater say in company matters and through indoctrination with an ideology of the "firm as family."

However, shareholders would be difficult to reconcile with the overall goal of fast growth. Among the three interest groups, they were least crucial for growth. The reformers concluded that in a modern economy dominated by large-scale corporations, **capitalism would work better without capitalists, and instead with powerful managers.**

{See James Burnham, *The Managerial Revolution*: burnham.html}

Managerial Capitalism and the Firm as Family

Given such analysis, the reformers had their work cut out for them. Managers were elevated. This came naturally, since in large-scale organizations they are essentially private-sector bureaucrats. **Modern bureaucracy is modeled on the Prussian bureaucracy, which in turn was designed on the basis of the Prussian army**. Naturally, the military looked at managers as private-sector soldiers, and as controls strengthened, they were fully integrated into the military chain of command. In the end it extended down to the worker, who was a corporate soldier.

The doctrine of **the firm as an "organic organization" binding employers and employees together** and serving for the public benefit was officially implemented in 1938, with the establishment of Industrial Patriotic Societies in all companies. Joint meetings with management and employees were organized where **workers could raise their concerns and participate in management decisions**. At the same

{p. 18} time, **trade unions were abolished** and all union activity channeled to the company level. This ensured that concessions to workers would not become too large to endanger fast growth of the firm.

Meanwhile, the role of stockholders was cut down to size. The New Labor System proclaimed in 1940 that **the firm was not the property of the shareholders, but a communal organization composed of those who worked there**. Army Ministry bureaucrats argued, "It is necessary to transform stocks to interest-bearing securities, and the character of stockholders to recipients of such interest. ... In management it is essential to consider first and foremost the people who work for the firm. In one way or another, management, technology and labor all depend on the overall manipulation of people. This aspect of management is invariably more important than capital itself."9 New laws set limits on dividend growth. Beginning in April 1939, **firms with dividend rates of 10 percent or more** - about two-thirds of large firms at the time - **required a permit** from the Ministry of Finance to increase their dividend rate. This made stock investments less attractive. Moreover, since the assassination of Mitsui chief Dan Takuma, the zalbatsu families had increasingly been selling their shares to the public. This was not only in response to pressure from the military and bureaucrats, but also to mitigate the anti-zaibatsu feelings among the public.

It was soon found that **if firms within a group issued shares and simply swapped them among each other, the influence of outside stockholders could be reduced** without diluting group ties. Thus cross shareholdings rose in the 1930s, among the zaibatsu firms reaching as high as 40 percent of all outstanding stock during wartime.30 **This increased the independence of managers, as the new shareholders were other managers** with the same growth orientation.

The New Labor System: Creation of Japan as We Know It

Yet by 1943, the control bureaucrats and military felt that profit orientation of firms was still dominant and growth orientation insufficient. They found that managers were still afraid of shareholders. Although dividends had been reduced, **shareholders could still threaten managers during general meetings**. Thus as part of the 1943 Measures to Strengthen the Domestic System, **the corporate law was changed** and a new Munitions Corporation Law was promulgated in October of that year. **It eliminated shareholders' influence on firm management**. Instead, the authorities designated one manager as the responsible person for production in every firm. He was given the power to run the firm as he saw fit to achieve the twin goals of quantity and quality. He could not be sacked by stockholders and was dispensed from the necessity to obtain stockholder permission for his actions.3l He was only to be held accountable by the planning bureaucrats for the fulfillment of quantitative production objectives. The planners' powers were also strengthened, when in November 1943 the Cabinet Planning Board was united

{p. 19} with the Ministry of Commerce and Industry to form the powerful Munitions Ministry.32

In March 1944, **the annual share dividend was decreased to 5 percent**. Any residual influence by shareholders over profit allocation, fund-raising matters, and the appointment of managers was eliminated. They had been reduced to fixed-income investors without a vote. The bulk of profits were divided among reinvestment, salaries for managers and employees, and special bonuses for workers to reward specific productivity improvements.33

Since managers had been given great powers, they had to be prevented from boosting their own bonuses too much. So managers and employees received **salaries according to the number of years they had served** in the firm - seniority pay. Promotion was to be decided on relative merit. If a firm grew fast, the less able manager could be promoted also. In return, **employees and managers had to vow loyalty** to the firm. They were effectively **prevented from quitting, because other firms**, organized on the same principles of seniority and lifetime employment, **would not hire them.**

Welfare schemes for managers and employees were introduced that were the most advanced in Asia. The National Health Insurance Law of 1938 and the Personnel Health Insurance Law of 1939 provided virtually **complete health coverage** to employees. The 1942 Workmen's Annuity and Insurance Law for the first time required the payment of annuities in case of old age, disability, or death. In 1944 it was broadened to include other personnel and women.34

Creation of the Main Bank System

Large-scale firms vere the bureaucrats' friends. So several **"national policy firms" were set up, which evolved into giant conglomerates**. Most of them were stock companies, but the majority of the stocks were held by the government and shareholder influence was limited. The government chose the top managers, and bureaucrats oversaw company policy. The number of these firms jumped from 27 in 1937 to 154 in June 1941.35 In 1944, key producers of military supplies were designated as "munitions companies." In 1945, over six hundred firms received necessary funds to fulfill their production quota via one or two banks that had been allocated to them by the Ministry of Finance.36 This main bank was the designated "Financial Institution Authorized to Finance Munitions Companies," ordered to ensure a steady flow of bank loans to the firm as it required - a compulsory lending system. The "main bank" relationships lasted until today.

Banks were compensated against losses for risky lending, either through the government loan guarantee program or by being bailed out by the government if they got into trouble. In March 1945, the system was further expanded. Soon more than two thousand firms, including many companies not involved with munitions, had each been **assigned a bank** charged with tending to their financing needs. The **allocation of bank credit thus shifted drastically from other sectors to priority manu-**

{p. 20} **facturing**.37 And **bank credit accounted for almost 100 percent of corporate fundraising** by the end of the war. Funding through the stock market had ceased.

The Origin of Japan's High Savings Rate

As more and more purchasing power was given to the military producers who then made claims on the limited resources, **fewer goods and services were available for private consumption**. If consumers were to spend as much as they had in the 1920s, they would compete with the military and bid up prices. Inflation would be the result, and that would threaten labor disputes and worker unrest, as it did in 1937 and earlier. The solution was to **get the population to withhold their purchasing power by saving**. This would prevent inflation.

The first step was to encourage voluntary savings. In April 1938, a National Savings Promotion Campaign was launched that aimed at boosting the savings rate to 30 percent of GNP. Savings Promotion Committees and cooperatives mushroomed throughout government offices and private firms and among ordinary workers and neighborhoods throughout the country. An agency for the promotion of savings was established at the Bank of Japan (where it is still in operation today). Most of the savings took the form of **deposits with the postal savings system** or with banks. The result was underconsumption and a transfer of purchasing power from the household sector to the corporate sector.

Creation of the Trade and Business Associations

In the New Economic Order the visible hands of the mobilization planners directed resources from the top down by formulating quantitative output targets, which were then divided into the various industries and passed on to the control organizations that had been created in each industry. They exist until this day as the ubiquitous industry or trade associations. Thanks to the associations, the bureaucrats could deleg3.te the task of implementation and monitoring of theilordel s to the private sector. It was the control associations, not bureaucrats, that divided overall quotas into orders for individual firms and ensured compliance. Human resources were allocated similarly, achieving a historic transfer of labor from agriculture and nonpriority firms to munitions companies.

To organize industry more efficiently, firms and factories were amalgamated into fewer, larger units that could enjoy economies of scale. The economic structure became highly concentrated.

At the same time, the large firms found it efficient to subcontract production of certain components to smaller firms, who were dependent on them - virtual external subsidiaries.

The New Japan

The changes implemented between 1937 and 1945 reshaped the function of the firm. Under the slogan "Public interest above individual interest," the New Economic Order successfully transformed firms from private profit-seeking undertakings to quasi-public ones focusing on growth, not profits. The market mechanism of the prewar period was substituted by a system of planning and government guidance that used private property and rank competition as an incentive device. Import penetration was successfully reduced.38 Resources had been shifted from nonessential industries to the heavy machinery and manufacturing industries crucial for munitions. Textiles halved from 29.3 percent of total production in 1937 to 14.7 percent in 1941, while the machinery production share more than doubled trom 14.4 percent to 30.2 percent.39 Private-sector savings rose from only 9.1 percent in the 1920s to 54.8 percent of GNP from 1941 to 1944.4° Real GDP grew by 25 percent during the war years (from 1940 to 1944).4l Munitions production grew 197 percent between 1941 and 1944.42 **Labor was fully mobilized and shifted from agriculture to industry** in a transformation that irreversibly rendered Japan an industrialized nation.43 **Unemployment had been eliminated**. The planners of the war economy achieved the goal of maximizing output from the available resources.

Introduction of One-Party Rule

On the political front, the military and reform bureaucrats felt that a system had to be created that would keep meddling politicians at bay. For this purpose, political parties were simply abolished and **all politicians united in a one-party system, as pioneered by the Soviet Union**. The single party was called the Imperial Rule Assistance Association. The police force was reorganized in an attempt to increase surveillance of individuals. A system of neighborhood police checkpoints was developed, which put up police microstations in virtually every corner of the country and enlisted **senior citizens in each neighborhood as police informers** (the system is intact today). Japan also became the most advanced social welfare state in Asia. Schooling was transformed, agriculture revamped. The changes were long lasting.44

Japan's System: An Economy at War

By the time Japan surrendered in 1945, most key features of the postwar economic structure had been established and Japan had been transformed from the free market capitalism of the 1920s to the controlled, "Japanese-style" capitalism of the postwar era. The labor structure among large firms changed to low job mobility and high loyalty to the firm, lifetime employment, seniority system, company unions, and bonus pay. The corporate organization clearly separated ownership from control, allowed few outside board directors, left shareholders weak, and thus made low dividends and a growth orientation possible. A "dual" structure was created, characterized by a few large firms with many small subcontractors linked in business groups. Funding shifted to borrowing from banks. The role of the bureaucracy became more interventionist and "administrative guidance" was cru-

{p. 22} cia1. **Politicians did not make policies, and their influence was kept in check by the one-party system**. The war mobilization changed what previously was a largely agrarian society into an industrial workforce trained to serve according to military work schedules.

The sudden emergence of the war economy system in the short time from 1937 to 1945 should surprise economists and historians. First, the system itself is surprisingly consistent, logically coherent, and highly efficient. Taking one individual component alone, it would not work. Implemented in its entirety, as happened in the postwar era, it beat the free market system of other countries hands down and created the postwar Japanese "economic miracle."

How could the wartime planners so quickly design such a consistent and efficient system? They had gained invaluable experience in implementing and running this system when they were **experimenting with its prototype in Manchuria**, which had been under direct army rule since 1931. **The same bureaucrats then moved back to Japan to implement it there**. The Manchurian planners **did not have to invent it from scratch**, either; they **took most of their ideas from European** thinkers and economists, with **the biggest input coming from German**y.45

{p. 23} 3 Winning the Peace

An Economy at War

The Cold War Propaganda Myth of the Postwar Reforms

If Japan's postwar economic, social, and even political system was created during the war, then what were the U.S. occupation and the postwar reforms all about? General MacArthur's Occupation Administration was given orders to democratize, deconcentrate, demilitarize, and liberalize Japan. To implement this goal, first **the wartime laws and ordinances**, such as the National General Mobilization Law, **were abolished** and the control associations and other wartime organizations dissolved. **The military and their bureaucracies were disbanded**. The Munitions Ministry, at the heart of the war economy, was broken up in December 1945. So was the powerful Home Ministry, with its police apparatus, including the dreaded Thought Police. War criminals were brought to trial.

Second, the political system was reshaped. Japan was given a new constitution, which established **democratic principles and the freedom of speech and religion. Female suffrage and free elections** were introduced. Third, MacArthur's GHQ implemented three major reforms designed to dismantle the war economy system: the **breakup of the zaibatsu**, land retorm, and labor democratization.

Thanks to these high-profile reforms, it seemed that Japan made a break with the past and was about to become a free, democratic, and liberal capitalist country, partner of the United States, the leader of the "free world." This, at least, is how Cold War propaganda on both sides of the Pacific presented it.

At first glance it looks as if the U.S. occupation fulllled its official goal. But when the occupation ended in April 1952, its fruits were quite different from those it had promised. **Instead of dismantling the war economy** system and deregulating and liberalizing the economy, **the opposite had happened. The U.S. occupation** succeeded in **strengthening** and further entrenching **the fully mobilized war economy system.**

With the advent of the Cold War, some lobbyists in the United States were more interested in establishing **Japan as a "bulwark against Communism"** and hence urged that Japan's economy be strengthened as quickly as possible.1 "Japan hands"

{p. 24} in the State Department, such as prewar ambassador Joseph Grew, succeeded in pushing for far milder occupation policies than were implemented in Germany. Ultimately, interests in New York and Washington came to the same conclusion as the wartime economic planners did in the 1930s: that the visible hand of the government should be used to accelerate growth.3 Already by 1947, General MacArthur's democratization policies had been seriously undermined. Although there was no official announcement, a major U-turn of the U.S. stance vis-a-vis Japan had taken place. The GHQ now actively advanced the continuation and strengthening of the successful war system of total resource mobilization.

Reform by Relabeling

As a result, for all intents and purposes Japan's wartime economic controls remained unchanged even after the end of World War II. **The Munitions Ministry merely split into the Ministry of International Trade and Industry (MITI) and the Economic Planning Agency** (noticeably less menacing labels).4 The wartime control associations soon resurfaced as private-sector business associations of the various trades and industrial sectors. The postwar carmakers' lobby, the Japan Automobiles Manufacturers Association, for instance, was the automobile control association during the war. **The keidanren, the powerful umbrella organization of all sectoral associations, is the successor to the wartime center of economic control associations**. A random check into the history of many postwar companies and associations, not to mention laws, rules and customs, inevitably unearths wartime roots - whether it is the Tokyo Eidan Subway Corporation, the Japan Productivity Center, the Bankers' Association, the Association for the Promotion of Savings, or the neighborhood police reporting system.5

Certain wartime legislation was officially reintroduced soon after the war, especially by MITI and MoF: the Order No. 3 of the occupation forces of September 1945 declared the **continuation of economic controls. Foreign currency rationing** was reintroduced immediately. A materials supply and demand plan was drawn up in place of the materials mobilization-plan.6

The continuation of the war system was most blatant when it came to the monetary system and financial controls: the wartime Temporary Funds Adjustment Law of 1937 and the Ordinance on Funds Operation of Banks of 1940 remained effective. So did the Bank of Japan Law of 1942 (it was changed fundamentally only in April 1998). The Foreign Exchange and Foreign Trade Control Law, promulgated in 1949, was merely a continuation of the laws that started with the **Capital Flight Prevention** Law of 1932, the first series of laws that established the controlled war economy. It **lasted until April 1998.**

The close relationships between companies and banks that were set up during the war **also reestablished** themselves when the U.S. occupation ended, in the form of the powerful ***keiretsu*** and the main bank system. Even key parts of the postwar tax system can be traced to the war economy. The Enterprise Rational-

{p. 25} ization Promotion Law of 1952 established a depreciation system for **important machinery** with **very high rates of depreciation** and hence **large tax incentives to accelerate capital investment**. This furthered the corporate bias of overinvestment and underconsumption. Its origin is to be found in the Price Compensation System of 1943.

Supreme Rule of the War Economy Bureaucrats

It was not only the institutions of the wartime system that survived intact with only minor name changes. More importantly, there was virtually **complete continuity of wartime bureaucrats and managers**. While the troops were disbanded, the leaders and war planners who had run the war economy remained in their positions.7

General **MacArthur had decided to implement systematically the principle of indirect rule through the Japanese bureaucracy**, unlike the more direct rule established by the occupation forces in Germany. This **left the bureaucracy practically completely in place**. If anything, the power of the economic bureaucracy that had pushed for the war economy system increased after the war. Thanks to the U.S. occupation, their principal rivals for power, the military and the Home Ministry, had been disbanded. Another, somewhat lesser rival, the once proud Foreign Ministry, had also greatly diminished, as Japan's foreign policy was mostly made in Washington, not Tokyo. As long as they could agree with the goals of MacArthur, the economic bureaucrats at MoF, MITI, the predecessor of the Economic Planning Agency, and the Bank of Japan had become the rulers of Japan.

Even **though with the abolition of the National General Mobilization Law their powers were now "informal," this did not diminish them in practice**. The principal source of bureaucratic power, the licensing system, was still in place and terminology merely changed from "control," "planning," and "allocation" to "guidance" and "moral suasion." Since their private-sector counterparts were also largely the same people they had been working with during the war, strict obedience was assured. "Japan was placed under an American system of rule, but the ideological pattern remained exactly as hitherto."8

The Return of the Manchurians

The very bureaucrats and managers who had demonstrated excellence in running the fully mobilized war economy, whether in Manchuria or back home, received rapid promotions to even more elevated positions in the postwar system. This is not surprising, since of the economic war planners, hardly any were purged by the United States - forty-two Ministry of Munitions, nine MoF bureaucrats and basically no Bank of Japan officials.9 And **as soon as the U.S. occupation left, practically all the nonmilitary men who had been purged were rehabilitated** in order to fill the ranks that their seniority deserved. This includes wartime politicians and most Home Ministry bureaucrats who had been in charge {p. 26} of the Thought Police. A number moved into the Education Ministry to take care of postwar education policy in Japan.10

The wartime planners did not just move back to modest positions in the public arena. The suspected Class A war criminals took center stage in the 1960s and early 1970s in positions as high as Japan's prime ministership.11 **The most important postwar economic and political leaders came from the elite group of wartime bureaucrats, the "Manchurians."**

While Albert Speer, the German wartime economy minister, was incarcerated in Berlin's Spandau Prison, his Japanese wartime colleague, Nobosuke Kishi, became prime minister. Kishi had been the leading Manchurian control bureaucrat, and during the war he became the minister for munitions, heading the war economy. As such, he had been a key designer of the wartime economic system.12 He was also the nephew of Yosuke Matsuoka, **a general director of the South Manchurian Railway Company - the core of the Manchurian mobilized war economy and one of the largest companies in the world at the time**. Matsuoka was a staunch backer of the army and the Manchurian experiment, and later rose to become pro-German foreign minister of the second Konoe Cabinet (from July 1940 to July 1941).

Kishi and his brother, Eisako Sato (a former railway bureaucrat), were prime ministers for altogether ten years, between 1957 until 1972.13 Other prime ministers with experience of the wartime system include Yasuhiro Nakasone, a former Home Ministry official. A key figure later in this book, the governor of the Bank of Japan in the 1990s, Yasushi Mieno, was born in Manchuria, since his father was a top control bureaucrat in the Manchurian Railway, the cadre school of the wartime economy. Finally, one should not forget the emperor himself, who was also an active leader during the war and a willing collaborator afterward.14

Among the eleven major automobile manufacturers of postwar Japan, only Honda is a true postwar creation. Toyota, Nissan, and Isuzu were key producers of trucks for the military. The seven other carmakers switched to car production from aircraft, tank, and warship manufacturing. Nissan and Hitachi were the core of the conglomerate operaled by Yoshisuke Ayukawa, a supporter of the Manchurian experiment of the controlled economy. He moved the headquarters of his conglomerate, including Nissan, to Manchuria, where he named it the Mangyo (Manchurian Industries) concern. Ayukawa became a member of parliament after the war.

Even the postwar media scene is the result of wartime concentration legacy: The Nikkei and the Sankei Shinbun are basically the result of wartime mergers, as are many other firms. Dentsu, Japan's top advertising company, is the product of the wartime concentration of the advertising industry, which reduced the number of firms from almost two hundred to only twelve. "It recruited so many former military and Manchukuo bureaucrats that in the early postwar era it was often called the 'Second Manchurian Railway Building."15 Manchurian origins can also be found with many large publishing companies. The list of successful or important postwar companies, institutions, and individuals with Manchurian or war economy backgrounds is a long one.16

{p. 27} LDP - "Bureaucratic Rule Assistance Association"

The minor role of political parties in forming serious economic policies in postwar Japan is well known. It remains to say that the unification of several parties to create the so-called Liberal Democratic Party in 1955 established the one-party reign (if not rule) that provided the **democratic fig leaf for the control bureaucrats who were actually running the country**. The so-called 1955 system closely resembled the one-party Imperial Rule Assistance Association system of the war era.17 The minor, and clever, improvement was that an opposition was allowed to provide an outlet for dissenters and to show the world that Japan was, really, a democracy.18 For forty years, until 1993, all governments were constituted solely by the LDP

With a Little Help from My U.S. Friends

Michio Morishima, a seasoned expert on Japan's economy, concluded: "As a result of this shift [in U.S. policy], Japanese capitalism re-emerged like a phoenix in a form almost identical to that of the prewar period."19 More than that: The irony is that only during the postwar era did the reform bureaucrats succeed in implementing their boldest reforms. During the war, they had failed to implement their ideas in two important areas. One was the **complete elimination of the capitalist class from public and business life - the purge of the powerful zaibatsu families**. The control bureaucrats considered this necessary to ensure continued growth orientation and the permanent neglect of profit maximization.20 The other was full-scale **land reform that would expropriate large-scale landowners and redistribute land to boost wealth equality**. This was expected to raise productivity and living standards in the agricultural sector. Despite their far-reaching powers, the reformers had faced stiff resistance during the war, as **both policies smacked of communism**. It was therefore anathema to the more capitalistically inclined leaders of the wartime period. Although the economic planners had to shelve these radical ideas, they remained convinced that they were necessary to enhance Japan's growth potential.

They did not have to wait very long. General **MacArthur volunteered to implement these socialist policies**, employing all the force of an occupation power. He **purged the capitalist class, the zaibatsu families** (the official reason was that they had allegedly been instrumental in setting up the militarist regime). They had mainly controlled their zaibatsu firms through holding companies, which owned the majority of zaibatsll firm stock. In 1946, holding companies held 167 million shares of stock. Since the total number of shares in all companies in the country was 443 million, they owned almost 40 percent of the total.21 **The zaibatsu owners were forced to sell their stocks to the public**, and the holding companies were forbidden entirely (until 1998). Zaibasu leaders, including illustrious members of the founding families - the core of the capitalist elite in Japan - were purged as war criminals or supporters of a criminal war and prohibited from further business activity. An

{p. 28} Anti-Monopoly Law and a Law for the Elimination of Excessive Concentration of Economic Power were enacted in 1947.

While the capitalist families disappeared from the economic landscape, their large conglomerates remained. Of the 325 firms scheduled for dismantling in 1948, only 18 were actually split up. By 1953, just a year after the departure of the U.S. occupation, the Anti-Monopoly Law had already been drastically watered down. Restrictions on stock retention, interlocking directorships, and mergers were relaxed, depression and rationalization cartels allowed. In the 1950s and 1960s about 30 laws were passed that provided exemptions to many industries from the Anti-Monopoly Law as well as the Export-Import Law. These included the Insurance Industry Law, the Aviation Industry Law, the Securities Investment Trust Law, the Fruit Industry Promotion Special Mearures Law, and so forth. Thanks to such vigorous intervention, the number of official cartels swelled from 162 in 1955 to 1,079 in 1966 - as we shall see, an important part of the war economy system.22 Most of all, the originally planned breakup of the five largest banks was abandoned, leaving the financial system entirely unchanged from its wartime setup.

Meanwhile, the companies regrouped as *keiretsu* business groups. While they were not held together by centralized holding companies, **the companies simply tied themselves together by issuing more shares and swapping them**, that is, by **rapidly expanding the cross shareholdings**. The war bureaucrats preferred this to holding companies, because the latter could be influenced by shareholders, but diffuse cross shareholdings established their system of capitalism without capitalists. Thanks to MacArthur's anti-*zaibatsu* reform, Japan's corporate giants had been rendered even more independent from shareholder influence and unaccountable to outsiders. Although banks could only hold up to 5 percent of stock of any industrial corporation, and since 1953 up to 10 percent, by arranging the purchase of stock by related keiretsu firms - each buying a small percentage of stock from each other's firm - they could cumulatively control over two-thirds of all shares. The resulting **bank-centered business groups were identical to the prewar conglomerates, only they were now controlled by managers, not the capitalist shareholders.** And in this managerial capitalism it was only the banks and ultimately the bureaucrats who had the say and could allocate resources as they saw fit.

Expropriation of Capitalists

The U.S. occupation also helped the wartime bureaucrats in implementing another one of their key goals. During the war, they had made attempts at sweeping land reforms. Politically unable to expropriate the large-scale owners during the war, the bureaucrats had instead opted for rendering them de facto irrelevant, just like the shareholders. **By having a government agency buy rice at a high price directly from the farmer while paying landowners low rents for their land**, they had severed the tie between tenant and owner and, crucially, between owner and land. Like shareholders, **landowners had become receivers of a fixed income without**

{p. 29} **actual say over their property**. However, a full-blown reallocation of landownership had remained impossible during the war. **The U.S. occupation did the job for them by reallocating landownership to the tenant farmers.** The postwar land reform almost completely wiped out the pre-1945 landlord class. This reallocation of land property went so smoothly only because the preparation had already taken place during the war. As a result, a major step toward social equality was achieved.

The U.S. occupation initially pushed for the democratization of the labor market, introducing new labor legislation and a nationwide labor union movement. Accordingly, the share of unionized labor rose from zero in 1945 to almost 60 percent in 1949. The increasingly **powerful communist influence** over this movement, with the background of the Cold War, **convinced the U.S. occupation to change course**. In July 1948 it restricted the right to form trade-based unions and abolished the right of civil servants to engage in strikes. From then on, **the wartime company labor unions, the Industrial Patriotic Associations, were revived** and mushroomed all over the country. After this, **all the other wartime labor practices, from lifetime employment to bonus payments, were reinforced**. This ensured that **real strikes declined sharply, because workers would only hurt their firm, and hence themselves**. The health insurance system introduced during the war essentially laid the foundation for the postwar Japanese social security system.

Kamikaze Capitalism: The Fight for Market Share

Thanks to the efforts of the U.S. occupation, the system of a fully mobilized war economy was led to completion in the postwar years - almost. Only in one aspect was the wartime economic model not yet complete, despite the tacit support from the United States. Indeed, there is a snag in the model that became visible during peacetime. **Since the structure of the firm is designed such that the goal is growth, not profits, managers will compete for market share**. Although concentration was greatly increased in every industry in order to rationalize production and take advantage of economies of scale, the planners always made sure that **enough firms would remain to compete against each other to prevent managers from resting on their laurels**. Since there are no trade unions any more, the company tie is more important than the fate shared with fellow employees in other firms. **Steelworkers thus compete with each other instead of uniting**. The management of one firm battles the management of another. Being in a firm with higher rank brought more prestige and had material benefits of higher incomes, pension plans, and more company facilities for housing, health care, and recreation.

In wartime, there was no problem with this, because firms focused on the production of their allocated quota with the simultaneous goal of highest quality. But in peacetime, bureaucrats soon found that their structure was getting too successful: When these market-share-oriented firms were let loose against each other without production quotas, fierce competition for market share would ensue. Like competition for ranking among managers in the hierarchy, the result of the war

{p. 30} system was that entire firms would compete not for profits but for ranking - the corporate pecking order decided by market share.

Since market share was the goal, firms would competitively lower prices; **cutthroat competition and a dumping war would ensue until no firm was making any profits**. In U.S.-style capitalism, the profit motive is the goal. Market shares are only a means to the ultimate end of higher profits. When competing against another firm, the profit motive would limit competition. As margins of both competitors approach zero, firms would stop lowering prices. They would be satisfied with profits and would be happy to coexist with each other. Not Japan's corporate warriors. Since the whole corporate structure was not aimed at profit maximization, low profitability, even losses, failed to stop the combatants from continuing their ruthless battle.

War Model Too Successful for Its Own Good

This was the inevitable result of an institutional setup where competition takes place between parallel groups of the same kind, as the "enemy" is so similar.23 It is also a major strength of the collectivist ranking competition on which the war economy is based: Society is divided into homogeneous groups, all ranked, and competition exists between those in the same category for ranking.24 "The pursuit of maximum growth has serious industrial and macroeconomic consequences," notes an observer of the phenomenon.25 The war-mobilized model was so successful in inducing growth and market-share expansion that firms would not stop. This phenomenon was soon recognized by the bureaucracy and called "excess competition" (*kato kyo-so*) - competition beyond what is necessary and good for the firms. Firms would go deeply into the red and even borrow to subsidize their output. It was a war of one management against another. Profits were no consideration. Firms would fight until bankruptcy to gain market share. **There was no truce. The war system produced economic war until one side was destroyed.**

During the postwar era, however, firms were not given predetermined production quotas. Left to their own devices, the structure would produce many bankruptcies, higher unemployment, and excessively high concentration in each sector. Once the bureaucrats had identified the problem, a solution could be worked out. **The solution was the creation of explicit or implicit cartels**, usually administered by the trade associations (the former wartime control associations). A ranking of firms was established, and the guidance of the industry association ensured that firms would by and large leave the ranking unaltered; all the firms continued to compete, but just enough to keep the rankings intact.

Cartels Were Necessary

To many observers, cartels may appear to be a bad thing. However, **the cartels and industry associations fulfilled a crucial function**.26 Without them, excess competi-

{p. 31} tion would lead to economically wasteful excess production and dumping of goods below their production value. At the same time, the cartels and industry associations served the purpose of implementing the bureaucratic "guidance." The problem was that the Anti-Monopoly Law had rendered cartels and agreements illegal in many sectors, such as construction. **If they had been made public, they would also have drawn criticism from abroad**. Thus **the bureaucrats tacitly tolerated illegal collusion to fix prices and market shares**, the so-called *dango*, such as in the construction and public works sectors. Given Japan's economic system, they served the public interest, for collusion was aimed not at profits, but at maintaining marketshare rankings, while firms continued to compete for price and quality.

Despite the cartels and industry associations, however, the competition between firms remained so fierce that "excessive competition" was the biggest weakness of the mobilized economy set-up. Until the 1990s, it seemed to be the problem that Japanese firms produced too much, invested too much, competed too much, and grew too much.27

The Mobilized Postwar Economy

The militarization embraced people's daily lives: Western-style trousers had replaced the kimono during the war, and rationed food and consumption had standardized consumption patterns. The thought that consumption was bad and savings good had been hammered deeply into the psyche. What previously was an agricultural and traditional craftsmen's workforce had now concentrated in big cities and was employed in factories: "They put on industrial overalls and learned the life of bondage to the factory whistle."28 All this thanks to the war.

The wartime shift of labor to the heavy manufacturing sector and the shift of production capacity away from light industry, especially textiles, which dominated the prewar economy, laid the foundations for the rapid industrialization of heavy and chemical industries in the postwar era.29 The increase of technical schools from less than a dozen in the early 1930s to more than four hundred in 1945 was due to the science and engineering requirements of the military, which exempted these fields from military service. By the end of the war the number of engineering students had tripled compared with a decade earlier.30 Quality control had been a major concern of the military, which rigorously enforced norms and standards set by the Industrial Standardization Law of 1940.

The relationships forged during the war between banks and companies, large firms and their small suppliers, and bureaucrats and the industry associations provided the framework for postwar success. In the 1960s, more than 40 percent of the parts suppliers to Toyota had begun this relationship as wartime subcontractors.31

War technology was transferred to manufacturing consumer goods. Engineers and workers trained in this technology put their knowledge to making consumer goods. There are cases of **machine-gun factories switching to sewing machine production. Optical weapons factories became exporters of cameras and binocu-**

{p. 32} **lars**. Suppliers of military hardware, such as tanks, trucks, planes, and ships, became the postwar shipping, automobile and heavy industries giants. Upstart firms created and championed by the military during the war became postwar world leaders in their sector.

Exports, Not Bullets

The wartime ideology of the firm as family, fostered by the Industrial Patriotic Associations, was carried over unaltered to the postwar era.32 **Lives remained regimented, with company exercises in the morning,** military boot camps for new company employees, and **army-style discipline and obedience** to superiors. The ultimate goal of a soldier had also been transferred to the postwar corporate warriors **- loyalty unto death**, as documented by the stunning phenomenon of *karoshi* (death from overwork).33

Consumers and households were encouraged to withhold their purchasing power by saving, while firms were given funds to invest in the priority sectors. Their products had to be sold. In the early postwar years, the expansion of domestic demand was important for growth, based on enfranchised farmers and workers.34 By the early 1960s it became apparent that, **given the high domestic savings, the markets had to be overseas**. So instead of munitions, the priority industries were now export-oriented manufacturers.

Managers were the commanding officers, workers and salarimen the corporate soldiers. **The bureaucracies of MoF, MITI, and the Bank of Japan were the economic general staff**. All fought the total economic war against the world.

Exports were the bullets flying out, hitting world markets and often leaving **deep wounds in other countries in the form of high unemployment**. Imports were hits taken and had to be minimized. This was done with the wartime exchange rationing system, revived immediately after the war. **Importers required import licenses for each item**, which were granted only to producers in priority industries, such as the export industry. This system was used to impose **extreme restrictions on automobile imports, tantamount to total import ban,** while the infant domestic car industry was getting into gear. The more bullets were fired and the fewer hits taken, the likelier Japan was going to win the economic war it was fighting. **A trade surplus meant victory**. It seemed Japan was following the oft-quoted caricature of mercantilism, where trade surpluses had become an end, not a means to an end.

But the World Was Unprotected

The result could not fail to be even more successful than the war economy. Economically speaking, weapons are wasteful production, because they are consumed. The same factories now produced similarly high-value-added export goods, which now, however, earned foreign currency. The money could then be used to import other production factors, such as raw materials, or for reinvest-

{p. 33} ment. Thus instead of a steady drain on the system, as weapons production had been, exports would continuously strengthen Japan. The only limit would be the willingness of the world to put up with **a country that was still at war with the world in economic terms** - closed to imports and hence **piling up trade surpluses as if they were war loot.**

While domestically the bureaucrats and industry association leaders ensured that companies would be protected against the kamikaze-like market share expansion behavior, the rest of the world was not so lucky. The only place where the full thrust of Japan's totally mobilized growth-oriented economy was working unmitigated and without restraining cartels was the world market.

As the United States pushed the Western countries to welcome Japanese exports, the full force of Japan's war economy was unleashed onto the world. Ignoring profits and aiming at market share, Japanese exports soon dominated the **steel and shipbuilding** markets in the 1960s. European and U.S. firms, aiming at profitability, were soon driven out of business. The onslaught by Japanese **carmakers** followed. Subsidized by the underconsumption of the domestic population, they began to conquer world markets.35 Then, in the 1970s and 1980s, the entire U.S. **consumer electronics industry** was wiped out by Japan's militarized and mobilized exporters. As a consequence, unemployment rose in the United States and Europe.

U.S. economists were often puzzled by the fact that Japanese monopolization of many markets in the world **did not lead to concerted price rises to exploit monopoly profits**. Analysts still failed to see its intrinsically different organizational structure and dynamics as a scale-maximization machine. Profits were irrelevant for management.

Ensuring Access to World Markets

Before Japan could make these historic inroads into world markets, however, it had to ensure that the world would be open to its products. The major clubs of the postwar industrialized world community, the GATT (now WTO), and the OECD, guaranteed open markets for all its member countries. That is why Japan had been pushing for membership since the 1950s. There was only one catch: The membership rules said that **only countries with market-oriented and open economic systems could join**.

This provision was aimed at **protecting the members from countries that might dump their products while keeping their own markets closed** - countries just like Japan. European countries argued that Japan's application to join GATT should be refused until the country had deregulated its economy and opened its markets to the world. However, the Cold War was raging. **Japan being America's key ally in the Pacific, the Americans put politics before economic considerations.** Against the express wish of European countries (France objected particularly strongly), the United States used its dominant position to push through Japan's application.36

{p. 34} In response to GATT membership, Tokyo strengthened its tariff barriers - just in case these foreigners thought they could now export to Japan.37

The Japanese bureaucrats realized, however, that Japan would not be allowed to maintain its exemptions forever. Moreover, they longed for an even greater prize, namely, **membership in the prestigious OECD, the club of "advanced" countries**. And it was already clear that the United States would not allow quite as many exemptions from membership rules. There was one rule that Japanese leaders knew would ultimately have to be adhered to: **free flows of money and free foreign investment among member countries.**

At the time, much of the world had fixed exchange rates with the U.S. dollar under the Bretton Woods system (until 1971). This forced other countries to accept the U.S. dollar at given exchange rates. Japanese bureaucrats watched with horror as **the United States took great advantage of the system by simply printing large amounts of dollars**. The U.S. Federal Reserve had embarked on a major domestic credit expansion drive, and much of **that excess money was used to buy up European corporations**.33

Government-Organized Deception

The war bureaucrats scrambled back to their drawing boards to find a solution. Business leaders of all industries held meetings in their various industry associations. Everyone was keen to keep the world open to Japanese exports. But all were very much afraid of an influx of foreign capital that could take over corporate Japan and change the wartime system. Foreign investment was a threat to the war bureaucrats and business leaders. **Japan needed to "defend" itself against forced takeovers from abroad**.39 So what to do?

It was time for **a great act of deception**. What followed was, in the inconspicuous words of MITI, "a series of measures as a part of [the government's] effort to prepare for the liberalization of capital transactions to strengthen business and industrial structures in order to make them competitive with foreign firms."40

To take over a Japanese company, foreigners would have to buy shares on the stock market. So the bureaucrats used a weapon of their war economy arsenal: they had already successfully reduced the influence of the zaibatsu families and other individual shareowners by the system of **cross-shareholdings. More of the same was needed to keep the foreigners out**.

Assume there are two firms that have issued one hundred listed shares in the hands of a zaibatsu family. If both **issue two hundred more shares each and swap them**, the ownership and hence control of the original owner is drastically reduced; instead of owning the entire firm, the one hundred shares now entitle the zaibatsu family to only a third of the firm. Since the managers of both firms agreed beforehand not to sell each other's shares and also not to use the ownership to interfere in each other's businesses, it is nothing but a managers' mutiny to **expropriate the original owners and take over the firm**.

{p. 35} Companies Choose Their Shareholders

That, of course, was precisely what the wartime planners had wanted. The same would also work **for foreigners**, the bureaucrats thought. The only obstacle - a mere detail - was that **expropriating shareholders was now theft**. And theft was illegal, even in Japan's postwar mobilized economy. Article 280 of the **Commercial Law protected shareholders from dilution of their ownership** without their consent given at a general meeting of shareholders. During the war, such niceties could be dispensed with by invoking the National General Mobilization Law. As the world was to find out, the postwar power of bureaucrats was hardly any smaller now. Article 280 of the Commercial Law was simply rewritten. **In 1955, just in time for GATT membership** in September of that year, **the Diet revised and amended Paragraph 2** of Article 280. "The new provision allowed the board of a company to **issue additional shares and assign them to each other** - that is, they **dilute the present stock of shares without obtaining formal approval from the current stockholders**."41

Thanks to the exemptions to the GATT rules, there was no immediate need by companies to invoke this new clause of the Commercial Law. The law change therefore drew little public attention in Japan, let alone the rest of the world. Careful not to cause any headlines, **companies slowly but surely issued new stock and swapped it with their business partners**, such as subcontractors, and their banks.

The process accelerated **in the early 1960s, as Japan received clearer hints** by its allies **that it would be allowed to join the OECD soon, provided it deregulated international capital flows**. At the time, American capital outflows had increased even further and **U.S. companies were just about buying up the free world with their printed money**. France, Germany, and Britain received large inflows of foreign investment. This takeover by U.S. capitalism of European companies in the late 1950s and early 1960s came to be dubbed "*le defi Americain*" by a French contemporary. In this situation the **United States did not want their European allies**

to get any ideas about protecting themselves from U.S. foreign investment. Any exemption for Japan from the capital flow clause of the OECD membership rules was therefore going to be temporary.

"Japan could no longer use any reason to impose import restrictions and invisible trade regulations for balance-of-payment reasons, and instead became obliged to promote liberalization of capital transactions," to borrow the words of MITI strategists.42 **Japan still succeeded in obtaining eighteen exemptions to the OECD membership rules**.43 Moreover, companies stepped up their new issuance of stocks and swapped them with each other.44 **Though billed as a measure to "raise capital," no new money was raised**.

Instead, management had built up **an invincible defense against takeovers and outsiders trying to influence their policy**. Now let the foreigners come. Japan was open to their investment. **They would find nothing to buy**. Japan Inc. was simply not up for sale. Most shares were not traded, but held in stable interlocking rela-

{p. 36} tionships. Most large firms participated in the scheme, thus increasing their *keiretsu* ties. The degree of cross shareholdings between firms thus increased rapidly again in the 1960s. While in 1949 about 70 percent of all shares were held by individual owners, by the late 1980s this had dropped to a mere 19.9 percent of all shares traded on the Tokyo Stock Exchange.45 The lack of dominant individual holdings makes it harder for the dispersed individuals to assert their rights and influence management.

By 1966, the program to boost stable cross shareholdings was virtually completed. To prevent the possibility of criticism from abroad, the bureaucrats and business leaders decided to modify Article 280 to give the appearance of propriety. A large number of **small provisions were added that gave details of the circumstances under which management boards could issue new shares without shareholder approval**. And thus it came that the world never took notice of Japan's act of deception.

In the words of Paul Krugman: "Japan's situation with regard to direct investment is like its situation with regard to imports, only more so. De jure, Japan is wide open ... de facto, foreign firms in Japan face endless informal obstacles."46 **In 1988, Japanese companies acquired 315 firms abroad. Foreigners, however, bought only 11 firms in Japan**.47 Even when foreigners managed to obtain large stakes, such as T. Boone Pickens, who acquired more than 30 percent of the shares of Koito, a parts supplier within the Toyota *keiretsu*, this did not guarantee influence on management. **Pickens failed to gain representation on the board of the company in which he held a "controlling" stake and felt forced to sell out**. The extremely low amounts of direct investment by the world into Japan has been an important reason why foreign firms have found it hard, if not impossible to penetrate the Japanese market. In Japan it was not shareholders that chose which company's shares to buy, but **companies that chose their shareholders. Foreigners were not favored.**

Japan as Perpetual War Economy

Thanks to this maneuver, by the early 1970s the war economy had been more firmly established than ever since bureaucrats and the military set out to mobilize it in 1937. Japan's bureaucracy had managed to realize its wartime dream of a management entirely free from the profit-oriented interests of individual ownership. The wartime vision of managers not aiming at profits, but their own goals, had become entrenched reality. And managers' aims are advanced best when the firm grows - growth for the glory of the nation. A mobilized war economy had been established, a nation run by public and private bureaucrat-soldiers in the fight for economic supremacy.

Perceptive observers, especially within Japan or in Europe, pointed out the important role of strong government intervention.48 **While the Cold War lasted, U.S. opinion leaders did not allow such critique** to come to bear. But it was clever

{p. 37} intervention. Bureaucrats had also learned during the war not to pick winners but to treat worthy competitors equally. As long as companies met certain standards of rationalization, they would receive equal government assistance. Targeted competition was always used to give firms and their employees maximum incentives to work hard. When subsidies were decided for an industry, firms had to compete against each other to obtain them. Bureaucrats employed conscious organizational design to shape incentive structures toward the desired outcome.

The Emperor's New Clothes

Their clocks gave it away, but nobody noticed: The Japanese did not set them back to zero in 1945. The official Japanese calendar counts years by the rule of the emperor. After 1945, the Showa emperor, Hirohito, took off his military uniform, in which until then he had been seen in public for most of his reign. He was given new clothes. But he remained in office. And the clocks just ticked on. Nineteen forty-five was far from zero hour. It was not even half-time of the official calendar, **the Showa era**, which **ended only in 1989, sixty-four years after Hirohito began his reign. Modern Japan can be understood much better when the entire Showa era is considered.** The ascendance of the Showa emperor in the 1920s is where we must start if we want to trace the true origins of the postwar Japanese economic, social, and political system.49

{p. 38} 4 The Alchemy of Banking

Money

Conscious institutional design by the war economy bureaucrats created the structures for a growth-oriented economy. The designers likened their system to an "organism" that worked like a body. Structures alone, however, are like a body without blood. What is missing in our description is the lifeblood of an economy, the liquid that is oiling the wheels of commerce: money.

Since humans abandoned barter several thousand years ago, money has been at the center of economic activity. It is therefore not surprising to find that money, its creation and allocation, also took center stage in Japan's war economy.

Just What Is Money?

Unlike the leaders of Japan's war economy, many economists today dispute the crucial role of money. It may surprise many readers, but it is probably fair to say that **many economists do not know what money is**.1 Things were easy when only gold and silver were used as money. But in a modern financial system it is not so obvious how to measure money. Most economists define money as the sum of central bank cash and bank deposits. However, it is not clear whether only short-term, long-term, other types, or all types of bank deposits should be included in such a measure. That is why central banks now publish a whole menu of so-called money supply measures deposit aggregates ranging from the narrow M0 (cash in circulation and bank deposits with the central bank) to M4 or wider aggregates (including all types of deposits).

Despite the multitude of measures, none of them seems to be particularly useful, because **none of the M-aggregates has a stable link with economic growth**.2 This is a headache. One of the few things most economists agree on is that **money supply growth and economic growth should move closely together**. But in the 1980s, money supply measures in many countries expanded much faster than GDP growth.3 By the mid-1980s, both the Bank of England and the U.S. Federal Reserve had announced that they had lost faith in the M1, M2, or M3 type of money-supply measures and were abandoning monetary targets altoether. Since then it has become quiet around monetary theories.

{p. 39} Big Interest in Rates

Today, most economists have no interest in the role of money in the economy. The latest **macroeconomic theories argue that money is "neutral" - just a veil over the tangible economy**. Economic research, these economists advise, can therefore safely ignore money.4 **The big mysteries in economics - why we still have** business cycles, stock market **booms and busts, large-scale unemployment**, and crises **- are said to have nothing to do with money**.

Though ignoring the quantity of money, mainstream modern economics pays close attention to its price - **the rate of interest**. The question whether the U.S. Federal Reserve will raise interest rates or not galvanizes experts and millions of investors. Unlike the quantity of money, interest rates can be accurately measured, and the latest data are available frequently. Many economists also believe that interest rates indirectly tell us about money. If interest rates are low, they say, there will be more money, and if they are high, the money supply must be shrinking.

Money Mattered to War Bureaucrats

While today such neoclassical economics is most widespread, in the 1930s the similar theories of classical economics were taught at leading U.K. and U.S. universities. The conclusions were the same. The war economy bureaucrats studied the classical theories. But they could not explain events very well. Links between money supply and growth were weak (such as in the United States in the 1920s). There was also no unique connection between interest rates and the quantity of money. Sometimes interest rates were low, but the quantity of money could be low as well. Worst of all, sharp reductions in interest rates, such as in the 1930s in the United States, did not seem to stimulate the economy (while for a long time in the 1920s rising interest rates did not seem to slow the U.S. economy).

When the world was in the grip of the Great Depression, classical economists argued that lowering interest rates would be enough. No government intervention was necessary, as the free markets would stimulate the economy on their own. But the invisible hand seemed to create more and more unemployment and starvation in the United States, where the recession lasted almost a decade. **The reform bureaucrats instead turned to the anticlassical theories developed by German economists**. They offered a different explanation of how the economy works. Much of their insights were drawn from a detailed study of history, which they believed offered important clues to an understanding of the economy - and the role of money.

The Power of Money

Going back in history, we find the oldest advanced monetary system in China. It lasted for several hundred years, until the era of Mongolian rule. It is at this time

{p. 40} that a detailed description was delivered to Europe in the form of **Marco Polo's report of his twenty years spent in Kublai Khan's China** in the late thirteenth century. Marco Polo was a trained merchant, and his book The Travels is full of information and insights concerning the Chinese economy. He did not fail to give an account of the most advanced monetary system at the time.

The world's first paper money was launched in the tenth century in China by the ruling Sung Dynasty. In this advanced monetary system, there was no doubt about **what money was: the paper money issued by the emperor and stamped by his seal**. He was the central bank. **No other institution was allowed to create money, on penalty of death**.5

The emperor was directly in control of the money supply. This meant that he could stimulate demand by creating more paper money, or cool the economy by taking paper out of circulation. He also determined who could gain control over food, raw material, weapons, and the latest technology, by creating and allocating paper money at will. He was an absolute ruler in every sense, in control of all the resources of his empire.6 **Marco Polo** vividly **describes this advanced monetary system,** which had been in place **when he visited China under the rule of Kublai Khan**:

{quote} It is in this city of Khan-balik that the Great Khan has his mint; and it is so organized that you might well say that he has mastered the art of alchemy. I will demonstrate this to you here and now. You must know that he has money made for him by the following process, out of the bark of trees - to be precise, from mulberry trees (the same whose leaves furnish food for silkworms). The fine bast between the bark and the wood of the tree is stripped off. Then it is crumbled and pounded and flattened out with the aid of glue into sheets like sheets of cotton paper, which are all black. When made, they are cut up into rectangles of various sizes, longer than they are broad.... And all these papers are sealed with the seal of the Great Khan. The procedure of issue is as formal and as authoritative as if they were made of pure gold or silver. On each piece of money several specially appointed officials write other names, each setting his own stamp. When it is completed in due form, the chief of the officials deputed by the Khan dips in cinnabar the seal or bull assigned to him and stamps it on the top of the piece of money so that the shape of the seal in vermilion remains impressed upon it. And then the money is authentic. And if anyone were to forge it, he would suffer the extreme penalty.

Of this money the Khan has such a quantity made that with it he could buy all the treasure in the world. **With this currency he orders all payments to be made** throughout every province and kingdom and region of his empire. And **no one dares refuse it on pain of losing his life**. And I assure you that all the peoples and populations who are subject to his rule are perfectly **willing to accept these papers in payment, since** wherever they go **they pay in the same currency, whether for goods or for pearls or precious stones or gold or silver**. With these pieces of paper they can buy anything and pay for anything.7 {endquote}

Marco Polo also describes what today we would call **open market operations** conducted by the Great Khan through purchases of gold, silver, precious metals, or other supplies from his subjects:

{p. 41} {quote} Several times a year parties of traders arrive with pearls and precious stones and gold and silver and other valuables, such as cloth of gold and silk, and **surrender them all to the Great Kha**n. The Khan then summons twelve experts, who are chosen for the task and have special knowledge of it, and bids them examine the wares that the traders have brought and pay for them what they judge to be their true value. The twelve experts duly examine the wares and pay the value in the paper currency of which I have spoken. **The traders accept it willingly, because they can spend it afterwards on the various goods they buy** throughout the Great Khan's dominions. ...

Let me tell you further that several times a year a fiat goes forth through the towns that all those who have gems and pearls and gold and silver must bring them to the Great Khan's mint. This they do, and in such abundance that it is past all reckoning; and **they are all paid in paper money. By this means the Great Khan acquires all the gold and silver and pearls and precious stones** of all his territories.8 ... **And all the Khan's armies are paid with this sort of money**.

I have now told you how it comes about that the Great Khan must have, as indeed he has, more treasure than anyone else in the world. I may go further and affirm that **all the world's great potentates put together have not such riches as belong to the Great Khan alone**.9 {endquote}

Marco Polo's description seemed wildly exaggerated to his fellow Europeans. We now know, however, that **he was giving** what amounts to **an accurate description of the monetary system prevailing** at this time **in the Mongolian Empire**. Even his estimation of the Khan's wealth as far exceeding that of his counterparts in the rest of the world might well have been accurate.

At the time, European kings and princes could only dream of such wealth or such power over the economy and their dominions. Things had developed quite differently for them in Europe. The rulers there failed to understand the true nature of money. To them, only gold or other precious metals could be money. But **if gold is the main currency, it is impossible for a ruler to control the money supply**. Gold cannot be created at will. Rulers tried, though in vain. Thanks to their efforts, chemistry got an early start in the form of the doomed attempts at creating gold through alchemy.

Compared to their colleagues in China, European rulers could not really be considered fully in charge. They could not control the resources in their countries. Kings had to compete with their own subjects for resources. **A government that does not control the money supply has hardly any influence over its economy**. Such a government is not sovereign. The great Kublai Khan, emperor of China and the Mongolian Empire, would probably have shaken his head in disbelief if he had known that **European rulers could not issue money to implement public-sector projects. Instead, European governments had to rely on taxes**. Often tax levels were already close to the pain threshold, and money was still needed for government investments or expenditures. If the kings and princes still wanted to build roads, hospitals, and castles or raise an army to defend their country, more often than not **they had to borrow money**. No matter how absolutist or all-powerful they may have called themselves, when it came to money most European rulers had to ask for help.

{p. 42} The Goldsmiths' Alchemy

So who was in control in Europe? It seemed that whoever had accumulated a lot of gold would be able to stake the biggest claim on resources. In reality things were a little subtler. Although precious metals were the main means of payment, it turned out that they were too heavy and too cumbersome, and it was too dangerous to transport them each time when going shopping for larger items. Gold wasn't even safe at home. Soon the richer merchants and landowners started to look for safe places to store their gold and silver. **Who better to entrust one's gold to than the goldsmiths,** whose job was to work with gold and jewels and who therefore had safe storage places? They were well established and independently rich, so there was little risk that they would make off with anyone's gold.

When gold was deposited with a goldsmith, he would write a receipt to certify that it was in his custody. Depositors found this convenient: Why bother taking out the gold for each purchase when the new owner of the gold would deposit the gold back with the goldsmith again anyway? Since the goldsmith was well known, soon **the deposit receipts themselves were accepted in lieu of payment. The deposit receipts had become money**.

By about the thirteenth century, **paper money therefore also had its debut in Europe**. However, it was crucially different in its form, function, and implications from China's paper money. **It was issued not by the government but by a private group of businessmen**.10

The Biggest Trick in History

Most crafts in medieval times were organized in trade guilds. So were the goldsmiths. At their regular meetings they must have discussed the phenomenon of a lot of gold lying idly in their vaults as many depositors used the receipts as money. They probably realized fairly quickly that **they could make extra profits if they lent out the gold in the meantime**. The risk of getting caught without gold was low if they **helped each other in case of unexpected withdrawals**.

The moment the goldsmiths lent out some of the deposited gold to earn extra interest, two things happened. First, the goldsmiths committed fraud. **Their deposit receipts guaranteed that the gold was deposited with them**. Their customers relied on the fact that the gold was there. **But it was gone, lent out. So the goldsmiths strove to keep this from the public**. As long as the public did not know or did not understand, there was no problem.

Second, **new purchasing power was created**. While the receipts for the gold were used to purchase goods in the economy, the gold itself, when lent out, provided someone else with additional purchasing power that had not previously existed. The total amount of purchasing power in the economy increased. **The goldsmiths had expanded the money supply**. But unlike in China, where the government made the decision over creation and allocation of purchasing power, in

{p. 43} Europe it was the goldsmiths who could dictate who would receive money. Though unknown to the public, the goldsmlths' actions affected everyone. As they created more money, the number of claims on scarce resources increased.

Things became even better for the goldsmiths. They found that demand for loans remained steady. When they had already lent out most of their gold, they were unwilling to let the opportunity slip to earn more interest. So they figured that **they could further expand their lending by giving their borrowers deposit receipts instead of gold**. Put simply, the **goldsmiths could "print" money!** By doing so, they could provide purchasing power to whomever they liked. This time, three things happened: First, **the number of claims on resources, the money supply, increased** further. This created a larger potential for economic booms or inflation of consumer or asset prices. Second, the fraud reached significant proportions, as they issued fictitious deposit receipts far in excess of the gold left in their vaults. This created even larger profits borrowers would pay back in real money what the goldsmiths had not owned. It also created a larger potential for crises when depositors would demand their money back. Third, banking was born.

Penniless Monarchs in the Bankers' Kingdom

The goldsmiths soon gave up working with gold and jewels. They had hit on a far easier and far more lucrative business. **They charged interest for issuing paper slips that cost them nothing to produce!** They became wealthier and henceforth would be known as bankers.

The bankers had managed to do what kings, emperors, and alchemists had failed to do - they were creating money. They had found the philosopher's stone.11 They were the central bank of their time.

This had fundamental implications that were to change the course of history, for it meant that **the allocation of new purchasing power was not under the control of the government**. Europe's monarchs did not see through the deception. They naively believed that the bankers had large amounts of gold. When governments needed money and could not raise taxes further, **they too thought they had to borrow from the bankers**.

The irony was that **the bankers were just doing what the kings could have done themselves: issue paper money**. Yet **because the monarchs came to rely on their bankers to fund large ventures, ultimately the bankers gained great influence over national policies**. Soon it became doubtful who was really in charge of the country. The Old Testament says that the borrower is servant to the lender.12 Thus it came that the kings often had become servants. Bankers were the masters who created and allocated purchasing power.

The bankers, of course, had their own interests to look after. Greatest opportunities beckoned when a monarch spent a lot of money - and hence created national debt. Some princes were wise and failed to borrow. Then the bankers had to wait for helpful circumstances such as wars between princes. Wars are a prime

{p. 44} cause of borrowing and national debt. In times of war even the thriftiest prince would be in need of money. Was it surprising if, in exchange tor their invaluable services, bankers would ask not only for interest payments but also for special privileges, rights, titles, and lands? **If the monarch was recalcitrant, his war fortunes could suddenly falter**. Those bankers would do particularly well who had connections to **colleagues in other countries, including to bankers on the other side of the front lines**, who funded the ruler of the enemy country. Then the temptation must on occasion have arisen to **collude with the enemy's bankers**, because such "rational" behavior would maximize their joint benefit. Together, **they could then decide which king was going to win** - the one who had granted them the greatest privileges. They could **simply issue more money to their favorite** and, with deepest regrets, report to the other that they had run out of cash. If the latter didn't believe them that there was no more money he could simply be shown their empty vaults. After his defeat the spoils could then be divided. Too bad for all those soldiers who had died in the process.13

While Kublai Kahn and his predecessors were absolutely in control of their country through their control of the money supply, in Europe it was the reverse: The rulers came to be controlled by money and by those who were in charge of its issuance. **Not the kings, but their financiers were in charge.**

Money Is Credit

Until the advent of central banks (in the United States as recent as 1913), **private banks therefore printed and issued paper money when someone took out a loan**. The English language bears witness to this process, as even today, paper money slips are referred to as "bank notes." At the time it was still clear how money should be measured: It was the sum of gold circulating and all the paper money issued by the banks.

On the surface things seemed to change when **central banks** were introduced. These institutions, **usually founded and owned by the most influential bankers**, had received the monopoly rights to print paper money.14 Thus **all other banks became dependent on them**. This did not mean, though, that the banks stopped creating money. Bank money creation merely took a less visible form. If someone wanted to borrow from a bank, the bank could **open an account and create a new deposit entry**.15 This is "book" money, or bank money. It worked as well as gold or paper money. So **even today, private banks create most of the money supply**. Currently, **in**

most countries less than 10 percent of the money supply is paper money issued by the central bank. As in the days of an advanced goldsmith credit economy, banks today create and allocate tte vast majority of purchasing power in the economy.16

The classical economists thought that the way to measure this bank money creation was to count all bank deposits. This is probably due to the fact that the old bank notes were called deposit receipts. But on a net basis, the banks issued

{p. 45} new deposit receipts only when they granted new loans. **Modern M-type deposit aggregates do not measure circulating money. They measure savings**. The modern equivalent of the deposit receipt issuance by banks is not the accumulation of bank deposits but the extension of loans. Bank credit measures the money that is actually circulating.17

Seeing Trees, Not the Forest

Another reason why classical and modern neoclassical theories do not usually recognize the role of banks may be their focus on microeconomics, and the static nature of the theories. Thus economists often would only analyze one single bank, or one deposit or loan transaction. Combine this with **the usual textbook treatment of the credit creation in a fractional-reserve banking system**, and t**he true money creation power of banks is obscured**. This is why in most finance or money and banking textbooks, banks are today described as financial intermediaries that merely accept deposits with one hand and extend these as loans with the other. Banks are just like the stock market or other financial intermediaries, these textbooks say: institutions that transfer money from savers to investors.18

Banks' power of credit creation should not be played down, but explained in a way that makes this enormous power obvious - such as by pointing out that **a bank does not just hand out a deposit to others as a loan once - but more than ten times**. If you deposit $1,000 with a bank, and if the central bank requires banks to hold reserves of 1 percent, it is tempting to assume that the bank will lend out $990 and keep $10 (1 percent of $1,000) as reserves (as most textbooks also describe it). This is not what happens. **Based on your $1,000 in new deposits, the first bank can already lend $99,000 (and keep your $1,000, which is 1 percent of $100,000 as reserves)**. How is this possible? Where does the bank get the extra $99,000 from?

The truth is, **banks don't have money. They simply create it by granting "credit" to someone**. This does not cost them anything, as loans are created out of nothing. In the 1930s, this credit creation process took the form of **a manual entry into the bank's loan book ledger. Today it is but an entry into the bank's computer**. The more loans banks give out, the more deposits will be written into existence. If one bank gets more deposits than another, the excess deposits are passed along to the other banks that have a shortage (through the interbank market).

The Life Cycle of Money

The life cycle of money begins when money is born by the extension of bank loans. It does its job while circulating as purchasing power in the economy. The more credit a bank creates, the more purchasing power is exerted in the economy and used for transactions that otherwise would not take place. When the borrower spends the money, the receiver is likely to deposit it again with a bank. This is when money is "retired" from circulation. By drawing it from a deposit account, it

{p. 46} can be mobilized again. **Newly created purchasing power is eliminated again from circulation** - money "dies," so to speak - **when the loans are paid back.**

The power to create money makes banks special, and **quite different from stock or bond markets, which can only reallocate already existing purchasing power**.19 It also makes them more fragile. **Austrian school economists remain convinced that banking is founded on fraud**: the banks' promise that the money is deposited with them is not kept - nor could it be kept should everyone insist upon it.20 That is why the bankers wanted to have a central bank, to step in and print cash when necessary.

Credit Is Supply-Determined

A correct measure of **the "money supply" is simply the sum of central bank credit creation** (injected as a result of the net buying and selling of assets by the central bank) **and private bank credit**. Credit aggregates therefore have a far better correlation with economic activity than the M-measures of deposits that are emphasized in central bank publications.21 They also easily beat the information value of interest rates.

The trouble with interest rates is that they are not uniquely related to the quantity of credit. They can't be, because banks keep interest rates artificially low, in order to ration the credit market, and select among potential loan applicants those they prefer. In rationed markets, not the price, but the quantity determines the outcome. Interest rates can be low, and credit growth very fast. But credit growth can also be slow. That depends entirely on the banks' decisions.22

This means that the entire industry of interest rate watchers and analysts could spend their time more fruitfully in other ways. When interest rates go up, it is not clear that the economy will slow. Likewise, declining interest rates are no indication that the economy will accelerate. **Economic growth is determined by the quantity of credit, not its price.**

There is No "Capital Shortage"

Without an understanding of the credit creation process, economic theories also had to get other concepts wrong, such as the role of savings and the determinants of growth. Classical economics assumed that there is a given amount of savings, which pose a limit for loan extension and hence investment. In reality savings are not limited at any moment in time. They are not a constraint on loans or investment. If more money is required for investment, banks can simply create it.23

Occasionally economists worry about a "savings shortage" or "capital shortage," which they feel is holding back growth. There is no such thing. Savings do not impose a limit on economic growth. If necessary, banks can create more money, and hence create more deposits, which are savings. This will surely raise nominal spending and investment and hence nominal growth.24

{p. 47} The crucial question is, of course, whether the newly created credit is used for productive purposes or not. **If new money is used unproductively, it is going to drive up prices**. If it is used productively, it will not result in inflation. This is easy to achieve when economic resources are idle and there is unemployment. So especially during recessions, it is easy to ensure that new credit is used productively. Hence new money creation will result in a recovery, not inflation.25

The facts about money are simple. Yet they are not well known. Introductory textbooks of economics briefly mention that banks create money. But all the theories that follow ignore this fact. It took many centuries for Europeans to rediscover the truths that had been known in China as early as the tenth century and recognize that **money was intrinsically based on the laws of the state** and hence could be usefully employed by the government for economic development. Many European economists did discover the truth about money and banks in the eighteenth and nineteenth centuries, such as **John Law in Scotland and France, and Adam Mueller and Georg Knapp in Germany**.26 However, all their theories were soon superseded and are now forgotten.

It was fortunate for the bankers that a group of economists existed, the **classical and neoclassical economists**, who could be relied upon to **argue that money - and hence banks - did not matter**. In the battle for ideas the old and new classical economists had either the better arguments or the better funding. In any case, their theories became widespread and dominate the economics profession today.27

Credit: Key Tool for a Controlled Economy

Some wartime thinkers and reform bureaucrats followed a different creed of economics. They studied their German economists well and thus came to understand the truth about money and banks. They realized that the power of banks and the central bank to create and allocate credit rendered them key levers to control the economy and allocate resources.28 Like the Chinese emperors, they wanted to control money, in order to gain control over the country.

The institutional design of the war economy system created the framework within which resources could be allocated to produce economic growth. But it was the monetary system that was used for the actual implementation of resource allocation and output creation. It is money that holds the key to understanding Japan's success since it embarked on economic warfare in the 1930s.

{p. 48} 5 Credit The Economic High Command

Shifting from the Stock Market to Bank Funding

The paramount goal of the reform bureaucrats was to maximize economic growth - which would also maximize war production. By definition, growth is due to investment. And to invest, firms need money. **External fund-raising can take the form either of bank borrowing or of issuance of debt and equity - borrowing from the securities markets**. In the 1920s and early 1930s, Japanese firms mainly obtained external funding from the stock market. Similar to the United States today, between 1934 and 1936 bank borrowing in Japan accounted for an average of 18 percent of firms' liabilities, with equity finance responsible for 81 percent. However, less than ten years later, firms had switched the source of funding radically toward bank borrowing. In the period from 1940 to 1950, on average 60 percent of firms' liabilities consisted of bank borrowing and only 40 percent consisted of equity financing. The predominance of bank financing persisted until the late 1980s: In 1965. 89 percent of banks' liabilities were bank borrowings; in 1970. 85 percent; and in 1980, 87 percent.1

Again, the change of a major feature of the economic system - the switch from market funding to bank funding - did not happen by coincidence or due to market forces. The visible hand of the govemment purposely placed bank lending at the center of the war economy. Govemment officials saw many advantages in bank funding and hence suppressed funding from the stock or bond markets. Instead they used bank credit as the main tool to allocate resources within the war economy system.

Bankers Have a Heart for Managers

One reason why the war economy bureaucrats preferred bank funding was that they strove to empower managers over shareholders. Equity finance would have put shareholders in charge, and that might have directed the economy toward profits, not quantitative expansion. Bank borrowing eliminated this threat.

Instead of shareholders, company management was now monitored by their bankers, who had to ensure that their loans were not wasted. But the bankers were managers themselves. **The separation of ownership and control, which was engineered by the control bureaucrats, also included banks**. This meant that from the late 1930s onward, individual shareholder influence over banks had been minimized. Also, **the bankers were less interested in profits than in growth. Instead of charging high interest rates, they therefore wanted to boost their lending**. That would be possible only if companies grew fast and hence had a further need for borrowing. Thanks to bank financing, corporate managers had found a natural ally in their bankers.

Another reason was speed. In a state of war, priority industries must raise large amounts of money quickly. Bank financing beats market financing when it comes to speed and ease of fund-raising. All that is necessary for a firm to obtain funds trom a bank is the decision by the loan officer, who can make the money available at the stroke of a pen. Equity financing or even debt issuance involves many more steps and participants, from lawyers drawing up the deals to underwriting and placement in the market. This can take months of preparation and execution. War planners could not afford such a leisurely pace.

Banks Boost Savings

Providing money to key industries is only one side of the tasks authorities faced during the war effort, however. As priority industries increasingly obtained purchasing power and laid claim to the available - and limited - national output, prices would be driven up if consumption demand was not at the same time reduced. Continued strong private consumption would pit firms against consumers in the competition for scace resources. To avoid inflation and the social instability that could follow, authorities had to ensure that consumers increasingly withheld their purchasing power. Individuals needed to be encouraged to save.

In a stock-market-based financial system, savers would have to be encouraged to buy stocks or corporate bonds. But as savings instruments for the broad masses, these involve risks and require careful research. In a state of war, individual savers could hardly be expected to put their savings in bulk into debt and equity. Losses of savings may have caused social instability.

With a bank-based economic system, the authorities could simply guarantee depositors' money. Should a bank be allowed to fail, the central bank could bail out depositors. At least the principal of a household's savings was thus guaranteed. In exchange for high security, however, savers had to accept lower returns. This allowed more funds to remain invested.

From about 1937 onward, government officials encouraged savings with annual savings campaigns. The media were used to spread the message that spending is bad and saving is good. Local bank, credit union, and post office branches acted as the collectors of people's savings, ensuring that purchasing power would be withheld. Bureaucrats discouraged all other forms of saving by effectively making them equiva-

{p. 50} lent to bank saving, and stocks became like bonds or deposits, yielding a fixed, administered return. That yield was pushed down so as not to compete with bank deposits.

Bankers, the Money Creators

By far the most important reason why war planners preferred bank funding as the main conduit of resource allocation was that banks create most of the money in the economy. And they **make the crucial decision of who will get this money**. Their actions thus have a profound impact on equity, growth, efficiency, and inflation. By withholding purchasing power from one sector and allocating newly created money to another, the entire economic landscape can be reshaped.

Given this pivotal role of the banks, it is not surprising that the reform bureaucrats and war planners had developed a strong interest in them. The German economists they read argued that banks and economic growth were crucially linked.2 Economic growth can be accelerated if the inputs used - land, labor, capital, and technology - are increased. As we saw, the war bureaucrats had already found efficient ways of organizing the labor market and firms' management in order to ensure effective mobilization of land and human resources. The banks served as their main tool to maximize capital and technology inputs, direct resources and steer growth.

How to Fund Growth: Print Money

Technology is indeed nothing but new, more efficient ways of rearranging given resources. It is like a new recipe, which delivers a tastier and superior output that is then valued more by consumers. Innovators and creative entrepreneurs that have hit on a new recipe often have a problem, though: They have no money to found a company that could implement their idea on a large and viable scale. The entrepreneur could either get funding in the markets or borrow from a bank, and may not mind how the money is obtained. But for the whole economy there is a crucial difference. **If an investor funds the entrepreneur, the investor would have to pull money out of other investments** (such as bonds, stocks, bank deposits, or even other venture firms). As a result, **already existing purchasing power would be diverted to a new use**, and some other economic activity would have to be scaled down. Despite the innovation, there is no economic growth, as the national income pie is determined by the quantity of credit creation, which remains unchanged. By contrast, **if the entrepreneur instead borrows money from the banking system, additional purchasing power** would be created and **no previous projects need to be stopped.**

Productive and Unproductive Credit Creation

This sounds almost too good to be true. Could all new and good ideas be funded just by central bank money printing or bank loans ? In principle, yes. Normally, the

{p. 51} worry is that excessive money creation would result in inflation. However, **as long as the money is used for productive projects that also increase output, there won't be inflation**; **although more money has been created**, the money was used so cleverly that **there is now also more output**. Both credit and output would rise, and **prices would stay the same**. What many classical and neoclassical economists failed to recognize is that **credit both provides the demand for new goods and allows their creation**. It therefore simultaneously **brings about both the demand for and supply of new goods**. If, on the other hand, extra money was created that was then used not to implement new technologies and create more output, but simply for consumption or speculation, more money would chase an unchanged number of goods and services. Prices would be driven up and inflation would ensue.3

There is a downside, though. In a free market economy, banks can create credit and allocate it to anybody they wish, even to borrowers who put it to unproductive use. Ultimately, though, this would also not be good for the banks, because lending for unproductive purposes is much riskier. **Only when it is used productively is credit likely to generate the income that is necessary to pay interest and repay the principal**. However, banks do not find it easy to recognize the actual risk involved in their loans. **Each bank might think it will get the money back on its real estate loans. But taken together, all banks will end up lending more money to the real estate sector than can be used productively**. As a result, money is created, but no new output and no new income can be derived from it. Eventually lenders will be unable to pay back the loans. As the excessive credit creation turns into bad debts, banks become more risk-averse and reduce lending. This slows economic growth.

Putting a Check on Bankers

Banks are special, since they serve the public function of creating and allocating money. But it is not clear that bankers, when left to their own devices, allocate funds such that the welfare of the entire community is enhanced. **Banks may decide not to extend loans to a farmer who wants to introduce organic farming techniques**, because it might consider these ventures too risky or not profitable enough, **and instead allocate purchasing power to a real estate speculator** who does not add to social welfare. German economists were particularly critical of the U.S. experience of the 1920s, when banks were encouraged to create money and give it to speculators, who wasted it. They argued that **the crucial function of banks to create and allocate purchasing power had to be utilized for the common good** of the nation.4 Even though a government may be democratically elected, the bankers are not. The bank owners often belonged to a small number of families who had wide-ranging power, sometimes over entire countries. Commentators noted that especially in a U.S.-style democracy, bank credit should be regulated by the government to maintain equity and fairness. U.S. founding father Thomas Jefferson was for this reason always opposed to the establishment of a privately owned central bank, and the U.S. Constitution was designed to grant the right to issue money

{p. 52} specifically only to the U.S. government.5 The Japanese war economy bureaucrats agreed that they needed to monitor the activities of banks carefully. At the same time, they realized that bankers could be turned into their allies and helpers in doing their job. By "guiding" the banks, officials could direct newly created money to productive projects.6

Controlling the Controllers

Control over credit creation, however, had to include the central bank. The supply of money used in an economy is made up of the sum of the credit creation of the banks and the central bank. The latter can increase or reduce the amount of money in the economy. But it also wields enormous direct control over the credit creation of banks.7

Given their different understanding of the role of the state - namely, to serve the community - the Japanese bureaucrats could not accept that, even in supposedly democratic countries, **the central banks were owned by private bankers**.8 **How could one expect the U.S. Federal Reserve system, the Bank of England, and the German Reichsbank to serve the public interest when** in fact they were partly or wholly **owned and controlled by private bankers?**9 And closer to home the question was pressing: How could the Bank of Japan be left a joint-stock company, in large part in private hands?

In line with the German economists whose books they had studied, the Japanese war economy theorists believed that **the central bank should be controlled by the government.** And it should, in turn, exert control over banks to regulate the quantity and allocation of money creation, such that it would serve the nation's interests.10

When the reform bureaucrats realized the importance of banking in shaping the economy, they started to study how central bankers supervised the banks.11 Some central banks claimed to use reserve requirements as a policy tool. Others said they set the official discount rate and thus encouraged or discouraged credit. In reality, neither tool was very effective. The discount rate or short-term interest rates were not necessarily related to economic activity. And the reserve requirements were too blunt a tool to be used strictly. **If many banks failed to meet the reserve requirement, the central bank would be forced to lend enough money to the banks so that they would meet it, thus defeating the purpose**. The alternative, though, was to watch how banks would try to borrow money from each other to meet the requirements, pushing up interest rates so sharply that it could disrupt the economy. Due to this problem, central bank officials often say that they cannot control the money supply. Yet there is a way for them to control the quantity of purchasing power created by banks - **they can set loan-growth targets to banks**.

The Secret Control Tool

This was a method **pioneered by the German central bank, the Reichsbank**. It already had gained invaluable experience during the First World War and in the

{p. 53} 1920s in restricting overall credit growth to desirable levels and also in allocating the newly created money to preferred sectors. **During the 1920s, the Reichsbank, under its president Hjalmar Schacht, also provided strict "guidance"** to the banks regarding their loan extension. The discount rate - the short-term interest rate at which banks could officially borrow from the central bank - was still announced, but it had become more of a public relations tool. By 1924, inflation had been brought under control. But the Reichsbank's "guidance" continued virtually uninterrupted for years - indeed, until 1945.12

The procedure was simple: **Each bank had to apply to the central bank for its loan contingent for the coming period**. The banks then proceeded to allocate their contingents among borrowers. **Once the contingent was used up, the central bank would refuse to discount any further bills presented by that bank and would punish further credit expansions**. Since there was no legal basis for these credit controls, the Reichsbank relied on **"moral suasion,"** that is, intormal administrative pressure under the threat of sanctions that could be highly costly for the banks. One internal Reichsbank memo of 1924 dryly notes that the central bank wields "substantial means of exerting pressure," which "it will not hesitate to employ."13

Schacht, Credit Dictator

The credit control system imposed in Germany handed enormous power to the central bank. Since **the Reichsbank had been made independent from the government after the hyperinflation of 1924**, it could do as it wished.14 It was only a small step further to give the banks detailed instructions about the sectoral, regional, and qualitative allocation of their credits. Reichsbank president Schacht made ample use of this power. By giving instructions to banks about what type of industrial sector and even which companies to lend to - and which ones to cut off from lending - **Schacht engaged in a far-reaching structural economic policy, favoring specific regions, sectors, and institutions** that he considered "productive" and pushing for corporate restructuring. The latter was getting fashionable in Germany, the United States, and Japan under the label "rationalization." Schacht argued that **to advance rationalization, firms must merge and "uncompetitive" firms must be forced into bankruptcy**. Schacht put such structural changes above the need to stimulate the economy. Consequently, **unemployment remained a problem** throughout the 1920s.15

Commentators noted that "many injustices and disagreements about the details are unavoidable."16 Numerous observers argued that in a democracy such vital decisions could be made only by parliament and the elected government. Indeed, the Reichsbank had become the actual German government, easily superseding the fragile and short-lived Weimar governments in terms of influence on the economy. Governments fell at a hectic pace, but **Schacht remained firmly enthroned from 1924 until he resigned in 1930**, a period that turned out to be crucial for Germany's later development. Contemporaries recognized in him a {p. 54} "credit dictator" or "economic dictator" and called the Reichsbank Germany's "second government."17

Introducing Credit Controls in Japan

In Japan, the reform bureaucrats had studied the Reichsbank's methods and realized the enormous potential offered by central bank credit controls over the banking system.18 They had **dispatched officials to Berlin, based in the Japanese embassy or more directly at the Reichsbank**. This included **Hisato Ichimada**, who had been **sent by the Bank of Japan**, and who featured prominently as **the Bank of Japan's postwar credit dictator** (see the next chapter).

The first law to start up the controlled war economy - initially called a "quasi-war economy," since the measures were partial and the country was officially not at war - was the **Capital Flight Prevention Law of 1932 and the Foreign Exchange Control Law of 1933**. They were aimed at preventing money from being transferred abroad, and also served to regulate imports. The staff of the newly created foreign exchange control section inside the Ministry of Finance became an experienced core of economic controllers, adept at directing the flow of funds.19

Having come to power with the beginning of open hostilities in China in 1937, the reform bureaucrats moved to control the allocation of money through the Temporary Funds Adjustment Law of 1937. This law brought banks and their investment and loan decisions under strict control by the central bank and the Ministry of Finance. **Funding through the stock market was reduced to a trickle, and the banking system was relied upon for resource allocation.**

It was now time to use the central bank for the purposes of the war planners. "In the period before World War II, and particularly before 1932, the Bank of Japan did not have a close relationship with the commercial banks and the money market except in times of crisis, when it acted as lender of last resort."20 **In 1942, the war leaders brought the Bank of Japan directly under the control of the government** and its finance ministry by **translating Hitler's new Reichsbank Law of 1939 and introducing it as the new Bank of Japan Law**.21 Together with the capital flow and foreign exchange control laws, this completed the system of financial controls.

The 1942 law stated clearly that it was the central bank's job to work toward the full mobilization of resources to achieve maximum output growth. Article 1stated that "the purpose of the Bank of Japan shall be to adjust currency, to regulate financing and to develop the credit system in conformity with policies of the state so as to ensure appropriate application of the state's total economic power." Article 2 stated that "the Bank of Japan shall be operated exclusively with a view to accomplishing the purposes of the state."22

To simplify the credit allocation regime, the number of banks was drastically reduced, from about fourteen hundred by the end of the 1920s to a mere sixty-four by the end of the Second World War. Similar to the control associations in various industries, the banks were organized in so-called financial control associations {p. 55} under the umbrella of the National Financial Control Association. As in other industries, it stayed in place in the postwar era, as the Japan Bankers' Association.23

Bank of Japan at the Control Levers

Banks were ideal as bureaucratic tools to direct resources. All that was needed was to impose detailed guidelines on bank lending, which the banks would have to follow. In order to ensure that firms with nonpriority investment projects would not compete for scarce resources by raising funds in the stock market, various administrative measures were employed to restrict equity finance and corporate debt issuance.

The Bank of Japan acted as the control center of the creation and allocation of purchasing power. Its governor headed the National Financial Control Association, which was operated by the BoJ and implemented the resource allocation plans worked out by the Cabinet Planning Board. The plan was structured on a top-down basis: First, **the needed output was decided upon. Then a hierarchy of manufacturers, subcontractors, and raw-material importers was determined. Finally, the banks were required to ensure that purchasing power was made available** for all the firms involved to be able to acquire the inputs into their production process. While shareholder influence was eliminated, competition was ensured on all levels, because the employees of companies and also of the banks were made to compete in ranking hierarchies for promotion and other rewards.

Thanks to them, resources could be allocated to industries of strategic importance - during the war it was the munitions industry. Based on plans for the overall output needs, **borrowers were classified into three categories**: A for critical war supplies, such as munitions and raw-material companies, B for medium-priority borrowers, and C for low-priority borrowers that manufactured goods for domestic consumption and items considered "luxuries." The allocation of loans to sectors in the B category was restricted, and **lending to sectors classified as C was almost impossible**. The manufacturers included in category A would be assigned a "main bank," whose job it was to ensure that enough loans were given to the firm in order to meet its production targets. The firms were themselves part of a hierarchy of subcontractors and related firms, which were grouped so as to ensure fast and efficient production of allotted output targets.24

This system quickly reshaped the economy. It **ensured that only priority manufacturers received newly created purchasing power**. Low-priority firms and industries were weakened, while the strategic firms and sectors grew rapidly. Manufacturers of luxury items, if not yet transformed for war production (such as the piano maker Yamaha, which retooled to produce aircraft propellers - a wartime legacy that enabled the firm to diversify into motorbike production after the war), simply could not raise any external funds. **Purchasing power was not used for unnecessary sectors or unproductive purposes**. Loans were allocated to achieve the goals of the war economy: maximization of the desired type of output.

{p. 56} Credit Controls Maintained After War

During the war the desired type of output was munitions. In the postwar era it was manufacturing of industrial and consumer goods. The system of controls worked so efficiently that it was completely carried over into the postwar era. A large number of the postwar links between companies in the various business groups, their subcontractors, and their main banks originated in the wartime credit allocation system.25

Making sure that banks complied with the bureaucratic lending guidelines was not difficult. During the war, the mobilization laws stated plainly that the private sector had to do what it was told by the bureaucracy, with extremely heavy penalties for noncompliance. In the postwar era, this was replaced by other incentives to comply with bureaucratic wishes.26 But even without these tricks, banks had to do as they were told in the postwar era, since **the vagueness of the legislation that hailed from the war era gave great power to the bureaucracy**.27 On that basis, **government officials could issue administrative orders or notifications (tsutatsu), similar to the wartime imperial decrees** issued by the bureaucracy. Private-sector institutions were not in a position to argue with the government. Banks were just as dependent on the bureaucracy as the firms were dependent on the banks. Bankers' resistance was further reduced by the continuation of the loan guarantee system, which minimized credit risk and ensured that banks would be bailed out if lending turned sour.

Economic growth would have been lower if Japan had followed laissez-faire policies without official intervention. Industries not crucial for investment and high growth, as well as consumers, would have competed for limited purchasing power. Indeed, given the abundance of labor in the postwar economy, **a free market economic system would have tended to allocate resources toward labor-intensive industries, making it difficult for Japan to build up heavy industries**. Without credit controls, **too much money would also have been allocated to highly unproductive uses, such as real estate speculation or luxury consumption**. Moreover, it would not have been possible to keep interest rates at artificially low levels, subsidizing the preferred industries. **Finally, free capital flows would probably have created the types of problems that occurred in Thailand and Korea in the late 1990s, when fixed exchange rates encouraged large-scale borrowing from abroad (largely needlessly, since domestic banks could have created the money)**, which triggered a crisis when foreign investors pulled out. Given the crucial link between credit and growth, it is no exaggeration to say that a major reason for Japan's successful postwar economic development has been the system of financial controls, which "guided" credit to high-value-added sectors and made the most of the wartime economic structure.28 The financial sector was the "general staff behind the battlefield in this total war called high economic growth."29

{p. 57} 6 The First Bid for Central Bank Independence

Alchemist Ichimada

In 1946, with the approval of the U.S. occupation, a young Bank of Japan official named Hisato Ichimada was appointed BoJ governor. He had previously received an outstanding training in the intricacies of credit creation. Having spent time at the crucial Banking Department, which deals with the banks and supervises the extension of central bank credit, **the BoJ sent him to Berlin, where, from 1923 to 1926, he witnessed Hjalmar Schacht's ascendancy to "credit dictator."**

He studied Schacht's credit control policies in detail and **regarded Schacht and his highly independent Reichsbank as a role model for the Bank of Japan**.1 Ichimada was in many ways deeply impressed by the experience. "What left the strongest impression on me in Germany was central bank president Schacht," he informs us in his memoirs.2 Despie his young age, he personally became acquainted with the great credit dictator. The two seemed to get along well. After the war, when Ichimada had become BoJ governor, **Schacht even visited his Japanese acquaintance (although Schacht could not stay long, as Ichimada lamented, since he was under investigation by the war crimes tribunal in Germany)**.3

After Ichimada's return to Japan he was again posted to the Banking Department. He worked at this key department uninterrupted for a total of ten years (from 1927 to 1937) - longer than usual. This, together with his posting to Germany, indicated that he had been tapped for higher office. After a short stint as Kyoto branch manager, he spent four years in the Auditing Bureau, quickly rising to become its chief in 1942. As an auditor, he monitored for what purpose loaned money was used - one of the key aspects of Schacht's qualitative allocation of funds. The main criterion, just as with Schacht's Reichsbank, was to decide whether loans were used "productively" in the eyes of the central bank.4

The time to make full use of his knowledge and experience came in 1942, when the system of a mobilized war economy was being fully implemented and the National Financial Control Association was established.

{p. 74} In the 1970s, the Japanese automobile and consumer electronics industries were on the ascendancy. In 1970, the U.S. television maker Zenith filed a suit charging that Japan was dumping television sets in the United States. This was hard to prove. Indeed, **the true cause of Japanese companies' incredible competitiveness was not explicit dumping by individual companies. It was systemic**. Japan's economy was designed to dump its products onto the world markets, **a whole nation engaging in social dumping**. In 1971, OECD countries had an overall trade surplus of $7.4 billion. Of these, $5.8 billion was accounted for by Japan.

As in other industries, American and European market leaders did not know what had struck them. Sure that their products were superior to Japanese "cheap mass production," they failed to recognize the single-minded determination of Japan's corporations to gain market share - a policy that **took no prisoners. It was aimed at annihilating overseas competitors.**

The United States had consented to the maintenance of the mobilized war economy in Japan because of the Cold War and the expansion of communism in Asia. The price had been high. The war economy, with its relentless orientation toward market-share expansion and disdain for profitability, could not fail to drive many American and European companies out of business. First in textiles then in steel and shipping, one industrial sector after another was being usurped by the Japanese economic machine. **The once-proud U.S. consumer electronics firm Zenith stopped producing radios in 1982. It is today owned by Korea's LG Electronics group.**

Revaluation

Remedies were being discussed. The Ministry of Finance quietly began looking into a revaluation of the yen. But a group of internationally minded officials and intellectuals in Japan realized that **the war economy system itself would have to be changed for America to get its way. Eventually, Japan would have to introduce freer markets and open itself up to imports**, thus allowing foreign companies to sell their products in Japan. But these reformers were in a minority. A system that had been created during the war and which had become increasingly entrenched in the decades of postwar success was not dismantled easily. Vested interests had been created in the bureaucracy that thrived on the power provided by the licensing system, businesses that earned monopoly profits in closed domestic markets and politicians that received support from the vested interests. Most of all, **ordinary Japanese benefited from the wealth the system had created for them and distributed relatively equally**. How could a general consensus be established that Japan needed to change?

The first doubts among the broader public about Japan's economic structure were sown in the mid-1970s. In many ways, this episode represented a test run of

{p. 75} the much bigger and more far-reaching events of the 1980s and 1990s. It certainly provided an important learning and testing ground for key Bank of Japan officials.

Busting the Dollar Standard

From the early postwar years and until 1971, the major world currencies were pegged to the U.S. dollar. For Japan, the exchange rate was ¥360/$ (the figure said to have been chosen by U.S. banker Joseph Dodge after he learned that the name for the Japanese currency, yen, also meant "round" or "circular").3 The U.S. dollar was in turn fixed to the gold price, and the U.S. Federal Reserve was officially obliged to convert dollars into gold on demand (to foreign treasuries or central banks).

As we saw in chapter 3, the dollar peg was convenient for the United States, because it enabled it to print more dollars that the world had to accept. In the 1960s, the Federal Reserve encouraged U.S. banks to step up credit creation. More and more dollars were created, and they spilled over as foreign investment. With these dollars, U.S. companies undertook large-scale purchases of European corporations - "le defiAmericain."4

In 1971, when the French realized that the Americans printed money and bought up Europe, they called the United States' bluff. They **took all those dollars that had been flooding into France and brought them to the United States, demanding that they be converted into gold**. This was the famed French raid on Fort Knox. Of course there were not enough gold reserves. Consequently, in August 1971, in what is often called the "Nixon shock," **the United States had to suspend the convertibility of dollars into gold**. The fixed exchange rate system collapsed and the U.S. dollar fell sharply on world markets.

Japan was taken by surprise. The BoJ and MoF waited another ten days before abandoning the pegged exchange rate. During this time, **the BoJ** worked hard to keep the yen weak. To do so, it **printed money aggressively, then went out and sold these yen to buy U.S. dollars in the foreign exchange markets**. Its foreign exchange reserves jumped by U.S. $5 billion in the space of the single month of August. Then, the yen rose, triggering the short-lived Smithsonian Agreement, which fixed it at ¥308/$ in December 1971.

The BoJ continued to attempt to weaken the yen by creating purchasing power. It did this by **buying up domestic assets, such as bonds, and paying with newly created cash**. Moreover, it felt that it needed to stimulate domestic demand sharply, because the sudden strengthening of the yen was going to hurt exports. So it **also used its window guidance control mechanism to make banks create significantly more credit**. What were at the time record amounts of liquidity were pumped into the economy.

In the end, the negative shock to exporters ended up being smaller than feared, because the yen had been greatly undervalued during the dollar peg system. Moreover, **Japan's economic structure essentially remained closed to manufacturing**

{p. 76} **imports**. Most **imports consisted of raw materials** that were needed for processing and eventual reexporting. The strong yen made the raw material imports cheaper. All in all, the new exchange rate was not an insurmountable problem for exporters.

The First Bubble Economy

So it turned out that the monetary stimulus by the Bank of Japan was greatly overdone. Banks, struggling to meet the high window guidance loan quotas ordered by the Banking Department of the BoJ, virtually begged firms to borrow money from them. Already flush in liquidity and fully invested in productive projects, the firms used the bank loans to fund unproductive activities: They **embarked on speculative land purchases**. This happened at a time when Prime Minister Kakuei Tanaka's "Plan for Rebuilding the Archipelago" and the Industrial Relocation Promotion Law he had pushed through while still MITI minister encouraged construction. Given the policy incentives and the seemingly limitless liquidity from the banks, **many companies joined the land rush. As the value of land as collateral rose, banks became even more eager to fund** the growing land speculation. Land prices exploded in 1972 and 1973. Capital gains on land holdings produced substantial paper profits. That made the firms' stocks attractive. With excess credit creation spilling over into the stock market, **a hitherto unprecedented stock boom occurred.** The Nikkei 225 stock index rose from 3,000 in March 1972 to 5,000 by the end of 1972. Capital gains by firms were enormous: In 1972, land capital gains amounted to Y15 trillion and stock gains to Y5 trillion.

The BoJ-induced credit boom was so large that it **began to spill over from asset markets into the real economy**. As investment and consumption demand picked up, **consumer prices and wholesale prices started to soar**. A lot of money was chasing a limited amount of assets and goods. The excess money was heating up most markets. The craze for speculation spread to golf club memberships, art and antiques, jewelry, and rare coins.5

All this happened *before* the oil shock of November 1973. The sudden jump in oil prices did not assuage the situation (although it was mitigated by the strong yen). Triggered by the oil shock, a stampede on certain consumer staples followed. This sometimes reached hysterical proportions, such as with the legendary Osaka "toilet paper run." In 1974, the consumer price index rose 26 percent year-on-year (YoY) and the wholesale price index 37 percent. The **crazy prices began to create social friction between those who owned land** or had access to bank finance and those who did not.

It is often thought that the pre-oil-shock asset inflation was the result of Prime Minister Tanaka's stimulatory fiscal policy. However, as we have seen, fiscal policy can affect the economy only if it is monetized. Thus the monetization - in other words, the BoJ's credit policy - remains the key variable. The best test of this argument is a comparison of the early 1970s and the late 1990s. In both periods there was significant fiscal stimulation. Indeed, the fiscal stimulation of the mid-

{p. 77} to late 1990s was far larger than the fiscal stimulation of the early 1970s. There is even the similarity of sharply rising oil prices, as between December 1998 and January 2000 oil prices almost tripled. Although Japan's dependence on oil has fallen, it is clear that this supply shock puts upward pressure on prices. **Traditional theory makes us expect an inflationary boom in the late 1990s in Japan**. However, during this time the largest deflation since the 1930s was recorded. This shows that we have missed a key variable. What is the main difference between these two time periods? It is neither fiscal policy nor oil prices, but the quantitative credit policy of the Bank of Japan.

The First Big Bust

By 1973, it had become clear that excess credit creation was being used merely for speculative land and asset transactions, thus pushing up asset prices. Urban land prices jumped by more than 50 percent from 1972 to 1974. Since these loans had been used speculatively, it was also clear that in aggregate, banks could not expect them to be paid back: only credit creation that is used for productive purposes can be paid back from the income streams the projects generate. **Credit creation used for speculation must eventually turn into bad debts. That will hurt banks, which then reduce lending**. As a result, economic activity falls and **the economy moves into recession - a classic case of a bank-based boom/bust cycle**.

Again, it was the Bank of Japan that acted as the catalyst for a turn in the business cycle through its key policy tool, window guidance. **From the first quarter of 1973, it imposed tight window guidance loan growth ceilings**. First, it reduced loan growth to the modest growth rate of 12.7 percent YoY. In the second quarter, it imposed a reduction of the loan increase quota compared to the same period a year earlier (by 16 percent). The tightening continued, with the window guidance loan increase quotas in the third quarter down by 24 percent YoY, in the fourth quarter down by 41 percent YoY, followed by a stunning drop of 65.4 percent YoY in the first quarter of 1974.6

The tight credit controls lasted two full years, until early 1975. Bad debts began to pile up in the banking system. Many small firms that had exposed themselves too aggressively to real estate and housing loans in the boom years found that they were insolvent. As this became apparent, a number of shaky credit associations faced full-scale bank runs. The Ministry of Finance and the Bank of Japan were forced to dispatch officials to Aichi Prefecture to reassure residents that their deposits in the local credit union were secure.

As the banks became paralyzed by the bad debt, they reduced lending. Small firms were hurt first, but eventually the whole economy suffered, as total credit creation slowed and economic activity therefore had to decelerate. Business protits nose-dived, slumping 84 percent in 1975. **Industrial production dropped 19 percent between late 1973 and early 1975**. Inventories soared and capital expenditure shmnk. Capacity utilization fell by 25 percent in 1975 compared to early 1973, leaving al-

{p. 78} most **one-quarter of productive plant and equipment idle in 1975**. **Unemployment soared**. The number of unemployed people rose to a postwar record by the end of the 1970s. Real GDP growth dropped precipitously from around 15 percent in the 1960s to virtually nil in 1974 - and Japan sank into its biggest postwar recession.7

After high inflation, **deflation became a problem: Prices started to fall in 1975**. The Bank of Japan watched as its roller-coaster window guidance policy created the most severe postwar recession. The slump indeed marked the end of Japan's so-called high-growth period. Japan had enjoyed two decades of double-digit growth - the fastest-growing large economy in the world - but by 1974 growth had come to a screeching halt.

Mieno's Debut

The recession lasted longer and was more severe than had been anticipated. **Despite a string of fiscal stimulus packages**, such as in February, March, and June 1975, and a repeated reduction in interest rates, **the economy did not respond**. Increased public works spending and infusion of credit by the public Housing Loan Corporation in 1976 merely raised the fiscal deficit. With rising unemployment benefits, by early 1976, not only the private sector but also the public sector looked shaky.

In late 1976 industrial production finally recovered, and reached its previous peak levels of October 1973 again. Japan's worst postwar slump was ending. The reason? The necessary and sufficient condition for economic recovery had been an increase in credit growth. **In late 1975 and early 1976 the Bank of Japan had raised its window guidance loan growth ceilings**. Who was at the controls of the economy? The vice governor of the Bank of Japan was somebody called Haruo Maekawa. From April 1975 to February 1978, the head of the Banking Department, in charge of implementing window guidance, was Yasushi Mieno.

Crisis Stimulus for Rethinking

When real GDP growth, after twenty years of almost continuous double-digit growth, suddenly contracted, it did not fail to trigger a lot of soul-searching. Many observers were puzzled about the relatively long and sharp downturn and began to see the Japanese economic structure as the main culprit. Indeed, in times of serious crisis, **the system, whatever its form, is likely to be blamed** for the crisis and voices are likely to call for significant changes. The slump spawned many studies at think tanks, including at **MITI**, which **concluded that Japan would not be able to maintain the previous high economic growth rates based on its export orientation**. Instead, it would have to revamp its economic structure.

Structural problems suddenly seemed a burning issue. There were a number of depressed industries in the manufacturing sector whose era seemed to have ended: shipping, petrochemicals, electric blast furnaces. soda, cardboard, and sugar refin-

{p. 79} ing. **MITI advised that these be transferred overseas, into other parts of Asia**. It recommended that **Japan become a headquarters nation, overseeing factories in many countries, such as in Asia and America**. The domestic economy needed to **move up the ladder to higher-value-added sectors**. Moreover, with the fiscal situation becoming critical, Japan's demographic problem was highlighted. Things looked bleak: a rapidly aging society with a pay-as-you-go pension system whose funds had been used up in vain attempts to stimulate the economy.

Calls for Japan to shift from export orientation toward expansion of domestic demand increased.8 To boost consumption, however, the structural impediments that had reinforced the savings bias and anticonsumption environment needed to be changed. Japan's mobilized war economy had been focused on scale maximization in strategic, mainly export, industries. However, the quality of life and standard of living of the domestic population had been neglected. Living space, housing, and medical facilities needed to be created. It was at this time that the critique of the Japanese as **"workaholics living in rabbit hutches"** was heard overseas.

Recession Blamed on Japan's System

A whole list of problems with the Japanese economic system suddenly became apparent thanks to the crisis. In the early 1980s a contemporary wrote about the shock of the 1970s as follows: "It is undeniable that the existence of inefficient and often self-righteous public corporations, the expansion of subsidies to agriculture due to over-protective policies, the inefficient national health care system, excessive administration intervention by the government in private enterprise, the proliferation of government-related institutions, an unclear division of responsibilities between the public and private sectors, and an unclear definition of the roles of the central government and local governments have combined to create swollen fiscal budgets and an enormous government bureaucracy."9

In the late 1970s, leading economists and public figures felt that "Japan is at an important crossroads now" and that "the time has come for a basic reexamination of public choices."10 The so-called **U.S.-Japan Wise Men's Group** reported in 1981 that there was a need for Japan to make much greater efforts to open its domestic markets to the inflow of goods, services, and capital to a degree equal to that of the United States.11

Sakakibara's Debut

Thanks to the crisis, serious criticism of the bureaucracy, including the hitherto all-powerful and almost untouchable Ministry of Finance, was heard in public for the tirst time in the postwar era. More and more observers argued that the Japanese tradition of a "strong nationalist bureaucracy" was now an obstacle. Even former bureaucrats called for deregulation, administrative reforms and a reduction of the size of the bureaucracy.12

{p. 80} **Two promising young Ministry of Finance officials**, members of the small career-track elite, joined the increasingly outspoken and critical debate about the future of Japan's economic system. Both had **taken time off from MoF for a stint in academia.** One was Yukio **Noguchi,** who has ever since remained in academia, and the other is **Eisuke Sakakibara, who subsequently rejoined the ministry and rose to become vice minister of finance in 1997**. Twenty years before, in 1977, in a pathbreaking article ("Analysis of the MoF-BoJ Kingdom") in the highbrow magazine Chlo Koron, Noguchi and Sakakibara were the first and only public figures to **clearly identify and acknowledge the true nature of Japan's economic system. They called it the "wartime system for total economic mobilization."**

Noguchi and Sakakibara correctly pointed out how the Japanese economy was far more market-oriented in the 1920s, how the control bureaucrats had introduced the postwar system during the war, and how this mobilized economy had remained fully in place in the postwar era. They also felt that this system could not continue to function with the current international environment. To them, the slump of the mid-1970s seemed evidence that the wartime system was "on the point of collapse."13 "From our standpoint, **the wartime system for total mobilization of economic resources is at last coming to an end**, and from now on **we must grapple with the real task of postwar reconstruction.**"14 Not considering the possibility of a reform that might preserve some of the obvious advantages of the system, they instead called for a fundamental **transformation of Japan's economic, social, and political system in the image of the United States**.

The reality was that this system was far too successful to be abandoned easily. It had created many beneficiaries, such as business groups, powerful bureaucrats, and intermediary politicians, but also including the majority of the Japanese population, whose living standards had risen rapidly. In the end, the deep shock of the 1970s was not big enough to be able to say good-bye to the war economy. **Noguchi therefore had to repeat his "farewell to the war economy" nearly twenty years later**.15

Credit Control Also Manipulates Public Opinion

The leaders at the Bank of Japan took note. They knew that the Bank of Japan was the only player that could create a recovery: **Ministry of Finance policies to boost the economy were aimed at lowering the discount rate or fiscal stimulation. Neither could work so long as the Bank of Japan did not expand credit creation**. Banks needed to be given money to write off their bad debts and clean up their balance sheets to be able to lend again. Meanwhile, the Bank of Japan, by acting as the banker to the country, could boost the economy by printing money. But as long as the BoJ failed to do this, the slump would continue.

By the 1970s, the BoJ's smoke screen concerning credit controls had been operating for a decade, and few observers, even at MoF, were aware of the real root cause and the crucial role of window guidance.16 **Neoclassical economics was beginning to make inroads in Japan**, and the economics sections of the BoJ churned {p. 81} out papers showing that interest rates were the key monetary policy tool. Further, the BoJ was semiofficially following monetarism. Hence the BoJ's role remained obscured.17 The public blamed MoF and the economic structure for the crisis.

Second Round Won

Visible elites can stay in power only as long as they deliver the goods. While Japan's economy was expanding at double-digit growth rates, people did not mind the strong grip on power by the government officials and especially the Ministry of Finance. The first and biggest postwar slump immediately triggered far-reaching critique of the mobilized economic system, including the legally most powerful bureaucracy, the Ministry of Finance.

Whether by accident or not, the decision makers at the Bank of Japan had won their second battle against MoF. When the BoJ finally let the economy recover in 1976, MoF was still licking its wounds. Yet the events of the 1970s were little more than a test run. It cannot be denied that the Bank of Japan had gained valuable experience in the mechanics of the creation and propagation of a real estatebased credit boom and the collapse that must follow.

{p. 82} 8 Mysterious Money

The Ebb and Flow of the Yen

Hot Money

We have arrived in the 1980s: an era of financial deregulation in the industrialized countries, and one of globalization of the capital markets. The supervision of banking and secunties industries was loosened, cartels in the financial sector were uprooted, and firms were exposed to heightened competition. Most industrialized countries lifted their restrictions on the movement of capital. As the international mobility of money increased, huge sums could be transferred between countries and between different kinds of assets in a split second.

Although the 1980s were also an era of booming international trade, **the flow of goods and servlces was outclassed by the volume of rapidly expanding capital flows**. During that decade the quantity of financial cross-border transactions reached a multlple of more than twenty times trade flows.1 Foreign exchange transactions reached half a trillion dollars in a day.

The increased use of offshore financial centers free from regulation further amplified the volume of "hot money" that was chasing highest returns around the globe. Large-scale institutional investors grew in importance. **Hedge funds, designed to make profits from market crashes, grew exponentially in size and began to dominate forelgn exchange markets.** Dealers, in front of keyboards and green monitors, had at their fingertips the execution of big-ticket international investment transactions that could affect countries in far-flung corners of the world. A switch in the beliefs of fund managers could send a torrent of money from one country to another, moving exchange rates and bond and stock markets worldwlde. Or so it was said.

Japanese Money Flooded the World

Though it may have appeared as if most industrialized countries increased their capltal exports, in reality the money originated trom only a few places. Since the

{p. 83} 1970s, the top capital exporters, namely, the United States, Japan, Germany, France, Italy, United Kingdom, Canada, Holland, Denmark, Switzerland, and Saudi Arabia, had accounted for about 85 percent of all reported long-term international capital flows. But **in 1987, 86.6 percent of the net capital exports of these countries were due to Japan alone**.2

From the mid-1980s until the end of the decade, **Japanese foreign investment all but dominated international capital flows.** Only forty years after defeat in the Pacific War, Japan seemed to hold the key to international money flows. The "global" phenomenon of international capital flows was first and foremost a Japanese phenomenon.

Japanese long-term capital flows multiplied from a net inflow of more than $2 billion in 1980 to an outflow of nearly $10 billion in 1981. However, they literally exploded over the next four years, multiplying by a factor of almost seven to reach a historic $65 billion in 1985. Then, over the next year alone, they doubled again, blowing up to a massive $132 billion. In 1987 another record was set when a tide of $137 billion swept over the exchanges, followed by outflows of $131 billion the following year. In 1987 the net long-term capital outflows were almost twice as large as the already record-breaking current account surplus. This financial tsunami easily overtook even the OPEC surpluses of the 1970s.

The money began to reshape the world in Japan's image. **Outbidding or swallowing rivals, Japanese money bought financial and real assets all over the world**. Japanese factories opened in greenfield sites in Scotland, Wales, and Northern England. Japanese cars were manufactured in the Midwest of the United States. Icons of U.S. business prowess, such as the Rockefeller Center, Columbia Pictures, and even Pebble Beach Golf Course, fell into Japanese hands. Japanese restaurants and hotels sprang up in the world's major cities to cater to Japan's corporate raiders. Hawaiian real estate came to be dominated by Japanese investors. The same happened in parts of California and the most attractive parts of Australia. **Asia was stuffed with Japanese factories, turning into Japan's new sweatshop**. It seemed that slowly but surely - perhaps not even that slowly - the world was coming to be owned by the Japanese.

This created fear and drew resentment. Labor unions in the United States started to mobilize their members against the Japanese threat. Economists developed strategies for the United States to avoid being completely owned by Japan. Some voices warned that Japan had lost the war but was now winning the peace by economic means 1 Management gurus urged business leaders all over the world to adopt Japanese-style techniques as the last resort to withstand le defri Japorlai.

Direct Investment Dwarfed by Portfolio Investment

Most analyses of Japanese money flows divide them into porttolio investment, which is "financial" investment, for instance, in government bonds, and foreign direct investment (FDI), which comprises purchases of "real" assets by foreigners, {p. 84} such as real estate and companies.5 Japanese net foreign direct investment (FDI) rose from $2 billion in 1980 to $6 billion in 1985. Outflows then accelerated further: by the following year overseas direct investment had more than doubled to $14 blllion and more than doubled again by 1988, reaching $34 billion. In 1989 and 1990 Japan's outflow of direct investment, at $45 billion and $46 billion respectively, was the largest in the world. By 1988 more than half of all FDI was dlrected at the United States and Europe.6

Though Japanese foreign direct investment reached historic proportions, until the late 1980s they made up only a small part of the long-term outflows, the greatest part being due to portfolio investments. Net portfolio outflows rose from $1.9 billion in 1983 to $23.6 billion in 1984 - multiplying by a factor of twelve - and then more than quadrupled again in the following two years to peak at $101.4 billion.7

These remarkable developments could not fail to leave a strong impact on internatlonal securities markets. In the 1980s, international bond markets had become unthinkable without the ubiquitous Japanese presence. At their peak in 1986, 77 percent of total net portfolio outflows were directed into bonds, the rest into forelgn stocks and shares. **Almost 90 percent of investment in foreign securities was in U.S. Treasury bonds**.8 J**apanese money mopped up a staggering 75 percent of all Treasury bonds auctioned off in 1986**.9 Portfolio flows peaked in 1986, while foreign dlrect investment rose steadily in importance. In 1990, at $48 billion, foreign dlrect investment had taken the lead over portfolio investment and Japan became the world's number one provider of direct investment.10

Actual Japanese Capital Outflows Were Even Larger

Despite the staggering sums, **the actual extent of Japanese foreign acquisitions in the 1980s is still understated by the official figures**. The true figures will probably never be known. The gap between data and reality did not open accidentally. F**aced with criticism of both the trade surpluses and the large foreign acquisitions, the International Finance Bureau of the Ministry of Finance concocted a clever way of reducing both figures**. The trick was to **count capital outflows as imports of goods**. Mlraculously, both figures "improve" in one stroke. Such creative accounting was undertaken with items such as offshore gold accounts and aircraft leasing.11

In the mid-1980s, a gold rush seemed to have hit Japan. In the first half of the 1980s, Japan had already become the world's foremost importer of gold bullion. In 1984, **192 tons of gold were shipped to Japan. In 1986 this had risen to almost 600 tons** - making up half of the entire world production of gold by noncommunist countnes. This **helped reduce the trade surpluses, because it boosted imports**. It is not surprising, then, that the one-off import of 300 tons of gold to mint coins in celebration of the sixtieth anniversary of the late Emperor Hirohito's reign was booked through New York.13

Gold purchases were far larger than gold shipments, however: Much of the

{p. 85} gold bought by Japanese investors never reached Japan. **Trading houses offered to store "imported" gold in London in order to reduce transportation costs**. Japanese securities houses aggressively pushed so-called **gold savings accounts, which nominally constituted gold investments - and hence gold imports**. However, the **gold "purchases" were conducted on paper only and gold never physically moved** from the foreign countries involved. But on a balance-of-payments basis **such investments were counted as imports to Japan**. In 1990 this capital outflow reached about $6 billion.14 The authorities' liberalization of gold transactions in 1982 had set off the process. MoF also gave the licenses tor the gold accounts, and it ordered the memorial gold coins.15 **None of these capital outflows was listed in the capital account. Instead, they lowered the trade surplus by that much.**

Some other ways to **artificially reduce the trade surplus** had been well tested in the past. In the late 1970s, when Japan's current account surplus had already produced trade friction with other countries, a scheme dubbed **the "samurai plan"** was devised by MITI and some of Japan's top banks, and was later supported by the Ministry of Finance.16 This scheme would allow cosmetic changes of the current account surplus. When foreign parties wanted to buy big-ticket items, such as aircraft, from other foreign parties, Japanese banks would step in, buy the item, and lease it to the one who wanted it. The Ministry of Finance would provide the foreign exchange reserves to the government-owned Export-Import Bank, which would finance the deals. Both Japanese commercial banks and the lessor would make sizable profits from this taxpayer-financed transaction.

Whenever an airline bought aircraft from a foreign manufacturer, Japan's government could potentially use it to reduce the recorded current account surplus, as the transaction would appear to be an import to Japan. It was crucial, though, to maintain the legal fiction that the lease was only temporary, since normally financing **leases would not count as imports**. In 1979, MITI thought that the scheme was a "trump card in reducing the surpluses" by an estimated $800 million in fiscal 1979 alone.17 The Ministry of Finance, worried that the IMF might see through the scheme, called it off after a year. However, in the 1980s, with the trade surplus ballooning again, a more sophisticated version of the leasing scheme, involving overseas subsidiaries of Japanese firms and banks, was finally implemented. Japan became a major player in the international aircraft leasing market, with the biggest aircraft-leasing firm fully owned by a Japanese company.

In addition to these misrepresentations of capital outflows, many capital exports took place that are not recorded at all: **The size of the "errors and omissions" item in the Japanese balance of payments was often larger than the entire current account surplus**. In 1989 in Japan, capital outflows amounting to 3 trillion were unaccounted for and listed in the balance of payments as "errors and omissions." That was almost half the size of the officially registered net long-term capital outflow of 6.6 trillion.18 At the time **the IMF warned that international statistics on international capital flows have become so patchy** that **"it has become difficult to ascertain each country's true capital (or current) account position** and, therefore,

{p. 86} how much saving the country has been providing to, or absorbing from, the rest of the world."19

Many **acquisitions by Japanese companies** were not measured by the balance of payments at all. One way of evasion is to **finance them via Japanese bank subsidiaries in London or New**

York. The bank sends the money from its Tokyo head office to foreign affiliates **as an "interoffice transfer," which is not recorded as long-term capital export in the balance-of-payments statistics**. Better still would be to send the money abroad as an interoffice transfer and then **reimport it as official capital inflow**. As a result, the officially recorded long-term capital outflows wlll appear that much smaller. Precisely such a scheme was introduced in the 1980s, when Japanese banks offered so-called impact loans to domestic customers. Under this system, a Japanese borrower took out a dollar loan. That was immediately swapped into yen, rendering it a normal yen loan for the borrower. But **the loans were booked through offshore centers and then counted as long-term capital imports in the balance-ot-payments statistics**. In other words, **a domestic transaction (a yen loan) was booked in such a way that it would appear as a capital import** in the statistics and would therefore reduce the total net capital export figures of the Japanese balance of payments.20

The Mystery of Japanese Money

Although the precise figures may never be known, the officially published figures of Japanese foreign investment were already large enough to worry many observers, not least because they seemed to defy economic logic. **In the 1970s, Japanese capital flows followed the textbooks: They were roughly equal in size to Japan's trade or current account surplus. Thus money earned from Japanese net exports was merely "recycled" back abroad as foreign investment**. Trade movements appeared to be the driving force, to which capital flows adjusted.

In the 1980s, this textbook scenario had disappeared. Now the momentum did not originate in the current account. **Long-term capital outflows preceded the current account surplus in timing and by far exceeded it in size**. Japan was purchasing far more assets abroad than it could afford due to its exports. **To fund its international shopping spree in the 1980s, Japan actually had to borrow foreign currency**.21

Economists had a hard time explaining this phenomenon. Some thought that the abolition of capital controls must have been responsible. Indeed, legal regulatlons were eased gradually over the 1980s, with benchmark changes of the foreign exchange law in 1980. However, most large institutional investors stayed well below their legal foreign investment limits in the second half of the 1980s. Moreover, the question remained why investors suddenly chose to invest so much abroad. Another frequently cited explanation was that Japan's capital exports were due to Japan's high national savings. But this ex post facto accounting identity does not tell us anything about *why* Japan's savings were so large.

In their empirical work, most researchers disaggregated long-term capital flow

{p. 87} figures into portfolio investment and foreign direct investment and then tried to build models that could explain them separately. The main model explaining portfolio investments was based on standard portfolio diversification: **Investors are assumed to reduce risk by holding a diversified portfolio.** The model can be tested by checking whether the information available on asset returns (in Japan as compared to the rest of the world) is sufficient to explain the actual investment pattern. In practice, this boiled down to checking **whether the differential between Japanese and foreign interest rates could explain Japanese capital flows.**

Unfortunately, these models failed to explain Japanese portfolio investment.23 **When the interest differential did not move much, Japanese foreign investment increased.** Even when the relative returns moved against foreign investment, Japanese money continued to flow out. That was particularly puzzling **when the yen rose significantly in the mid-1980s**, for it meant that **Japanese investors lost money over a protracted time period, as foreign investments lost their value in terms of the yen**.24 In the two years between January 1985 and January 1987, approximately 40 percent of the cumulative value of Japanese overseas investment had been wiped out in yen terms. Despite this, Japanese investors continued to invest in sizable amounts in U.S. and other foreign assets. This anomaly persisted over several years despite the fact that **the intention of the Plaza Agreement - namely, to strengthen the yen - was not in doubt.**

It had to be admitted that serious studies of Japanese foreign investment "have not been particularly successful in explaining the rapid growth of capital outflows" and many a report ended with the words that Japanese foreign investment was "hard to understand," "counterintuitive," or "something of a mystery."25 The dramatic surge of Japanese foreign investment remained an enigma tor the experts.

Reversal of the Tide

Economic models of Japanese foreign investment focused on the period of rapidly rising foreign investment. They failed to explain them and were even more helpless in explaining the events of the 1990s. **In 1991, as the Japanese current account was heading for new record surpluses, topping $90 billion, net long-term capital outflows had suddenly vanished**. Japan recorded $40 billion worth of net inflows of long-term capital, the first in more than a decade. **Japanese investors became net sellers of foreign securities in record figures**.26 Japan remained a net seller of foreign assets throughout 1991. From manufacturers to banks and real estate firms, Japanese money was suddenly retreating on all fronts.27

With increasing losses on their foreign investments, it had become apparent even to the last believers in the "profit motive" that **Japanese corporations, and in particular the country's financial institutions, had not invested for profits**. There were hardly any profits. As it turned out, even giants had not bothered to conduct cash-flow analyses and profit projections about their numerous foreign acquisitions.28

Researchers struggled to explain the puzzling aberration of **a record current account**

{p. 88} **surplus accompanied by a sizable long-term capital account surplus**. Standard analyses failed to provide an explanation of the extraordinary movements of Japanese foreign investment in the 1980s and the early 1990s. This gap in the economlc understanding of the world could be excused if it concerned the capltal account behavior of, for instance, the Principality of Liechtenstein. But the lack of understanding of the determinants of capital movements of **the biggest capital exporter in history**, whose money has directly affected companies, governments, and llves in many countries all over the world over a period of more than a decade, should not be excused easily. It is well worth researching what was behind these dramatic events.29

{p. 89} 9 The Great Yen Illusion

Credit Bubble and Bust

Mysterious Land Prices

In the 1980s, Japanese capital outflows were not the only phenomenon that puzzled economists. From the mid-1980s onward, land and stock prices appreciated tremendously. Between January 1985 and December 1989, stocks rose 240 percent and land prices 245 percent. In many countries, land prices tend to appreciate in line with GDP growth, thus leaving the ratio of land values to GDP around 1. In the United States it was as low as 0.7 in 1989. But in Japan it had risen to 5.2.1 By that time, real estate prices had reached unprecedented levels. Using market values, one could calculate that **the value of the garden surrounding the Imperial Palace in central Tokyo was worth as much as all the land of the entire state of California**. Although **Japan is only 1/26th of the size of the United States, its land was valued four times as high**. The market value of **a single one of Tokyo's twenty-three districts, the central Chiyoda ward, exceeded the value of the whole of Canada.**

Such figures should have told us that something was wrong. But **economists are trained to believe in "market outcomes." So they tried to justify the extraordinarily high land prices**. Some thought land scarcity was the reason. But even in crowded Tokyo, the ratio of available office space to the total land surface was merely 40 percent at the peak. Rather than being scarce, land was being used inefficiently. Almost two-thirds of Japan's population is concentrated in the six major cities, where land prices are high, while **land in sparsely populated provincial areas, remote from the six cities, is relatively inexpensive**.

Another favorite explanation for the high real estate prices was that **the productivity of land was simply extremely high**. If that was true, it should have been reflected in rents. But rents failed to appreciate as much as land prices. In the late 1980s, **residential land prices in Tokyo were up to 100 times higher than in New York City**.**Rents were only four times New York's levels**. Calculating the theoretical value of land based on rents, and taking interest rates and other variables into

{p. 90} account, economists conceded that market prices were far above the prices that economlc theory predicted.3 Land prices remained a puzzle to the experts.

Speculation

The answer to the puzzle could be found by asking one of those involved in the land-buying binge of the late 1980s. One would have soon found that they did not acquire land to earn money from renting out office space. **Their main aim was to make a quick buck by selling the land soon after. To them, land was simply an asset - one that was about to appreciate further.**

The same forces seemed to be propelling stock prices to dizzying levels. From 1984 to 1989, the Nikkei 225 stock index rose on average by 30 percent per annum. In December 1989, it peaked at an all-time high of 38,915. Just **as with land prices, share prices had risen far above what**

economic models could explain, for instance by corporate profits. **The ratio of share prices to corporate earnings doubled in those five years from 35 to 70**. The expected income stream from owning a part of the company could no longer explain the stock price. Studles used a variety of explanations, such as low interest rates, to make sense of such stock prices. But they all concluded that stock prices could not be explained by standard theories.4 Somewhat embarrassed, one major study suggested that stock prices could, at best, be explained by rising land prices. Companies who owned land were valued higher as land prices rose. But that left us none the wiser, as land prices had remained an enigma.

Free Money

Companies didn't mind if experts could not explain asset prices. They ran to the punch bowl while the party lasted. Firms borrowed money and invested. Or they issued new stock or corporate bonds. Little of that was invested productively. Most went straight back into stocks or real estate. With asset prices rising, **even staid manufacturers could not resist the temptation to try their hand at playing the markets**. They initially entrusted substantial sums to their stockbrokers who had set up so-called *tokkin* accounts in which they engaged in discretionary speculative investments in the financial markets. Soon they expanded their finance and treasury dlvlsions to handle the speculation themselves. The frenzy reached such proportions that **many leading manufacturers, such as the carmaker Nissan, made more money through speculative investments than through their core manufacturing** business.5

Laymen wondered how this could be possible. Too difficult to explain, the experts said. It was financial technology. The increased sophistication of financial markets had delivered the wonders of *zai-tech*.6 Many firms felt there was no time to ask questions; time was money. So they joined in setting up *zai-tech* operations - subsidiaries devoted to full-time speculation. Firms set up real estate sub-

{p. 91} sidiaries, banks set up nonbank financial firms to lend to real estate firms, and individuals mortgaged their land to get into the game. And all were buying land and stocks.

Economic Boom

Not all the hot money gushing around the economy in the late 1980s was used for pure speculation. **Substantial amounts found their way into corporate investment programs. Firms were finally able to implement all those projects that lack of money had forced them to shelve**. They now splashed out. **New factories were rolled out on greenfield sites in Japan and overseas. The latest machinery equipment was ordered and a generation of production facilities upgraded**. Shiny new marble-clad corporate headquarters rose in Tokyo's posh business districts. Luxurious employee residences were built in the suburbs, and glitzy resort facilities with tennis and golf courses for corporate entertainment sprang up by the sea and in the mountains. Tokyo Bay was filled up by land reclamation projects. **Real estate firms competed to construct the tallest building in the world.**

Aggregate investment soared, leading Japan on one of the biggest capital expenditure sprees in peacetime history: Between 1985 and 1989, Y303 trillion worth of capital investment took place.7 **Each year, Japan on average invested an amount equivalent to the entire GDP of France**.8 Corporate expense accounts ballooned as managers entertained each other lavishly and spent fortunes on corporate golf club memberships. **Like the Nikkei index, the index for golf club memberships had become a widely watched barometer of the state of financial markets**, and it only pointed one way: up.

As companies aggressively hired employees, **the labor market boomed** - so much so that there was **a general fear of a serious labor shortage**. Companies started to invite final-year university students on expensive trips to holiday resorts to entice them to sign up and get them away from other companies. **Unemployment hit a record low of 2 percent** in March 1990. With such a tight labor market, **personal incomes rose and consumption expenditures grew strongly**. Hence nominal GDP, which consists of consumption, investment in plants and equipment, government spending, and net exports, was pushed up to a growth rate of 5.5 percent on average from 1986 to 1990.9 Factories operated at maximum capacity utilizatlon.

More Mysteries

Yet despite the high growth rate and tight labor market, **inflation, as measured by the consumer price index, remained surprisingly low**. In 1987 and 1988, the problem appeared to be **deflation, as the consumer price index actually dropped**. Japan's economic miracle seemed to deliver just the right amount of growth for everyone to be happy and inflation to remain subdued. A "new era" had dawned in Tokyo. Japan's economic performance in the 1980s

{p. 92} attracted many admirers. Literally thousands of articles were written about the Japanese "new" miracle economy, and theories abounded as to just how Japan managed to succeed so brilliantly while other countries had problems with long-term unemployment and inflation. A common explanation by economists was that high and rising productivity explained the impressive performance of Japan's economy.

The Breakdown of the Monetary Model

It should have worried observers that economists failed to explain any of the unusual developments of the 1980s in Japan. **Economists were puzzled to find that they could not even explain Japanese GDP growth. Until then, economists had believed they had a good grip on what determines GDP growth**. Although there are many theories in modern macroeconomics about the economy (classical/neoclassical, Keynesian, monetarist, and fiscalist, to name the most important ones), they are all based on the fundamental relationship between money and the economy. They **all assume that the money supply is proportional to nominal GDP**. Economist Milton Friedman even called this relationship the most stable in economics with its reliability approaching that of a law of the physical sciences. 10

That science was in trouble. In the Japan of the 1980s, the links between the so-called money supply measures, such as M1 or M2, and economic activity had broken down. GDP and money supply did not grow in line with each other. **Money supply growth exceeded GDP growth**. The "velocity" was not constant anymore which implied that the "demand function for money" had broken down. This meant that something was seriously wrong with all of modern economics -

whether classical, Keynesian, or monetarist - for all varieties relied on the stable relationship between the money supply and GDP

The problem was also a practical one. With money and GDP parting ways, monetary policy, the main tool to influence the economy, had lost its effectiveness. If economic growth was not linked to the money supply anymore, then manipulating money could not produce the desired target GDP growth rate.

Things got worse. The most popular explanatory variable in economic models, **the interest rate, failed to explain economic growth or asset prices**. **It is often said that the low official discount rate of 2.5 percent, maintained from February 1987 to May 1989, was the cause of the bubble.** But interest rates were also not in any stable relationship with asset prices or economic growth.

Japan had troubled economists for a while. **It seemed to defeat the cherished tenet of classical economics that only free markets could lead to economic success**. Japan was obviously full of **regulations, cartels, and other obstacles to trade and competition**. According to classical economics, it should have been an economic disaster zone. 1l Yet Japan's economic growth was so high in the postwar era that it was called a "miracle." This high growth seemed to recur in the 1980s. Asset prices, GDP, and capital flows all moved in ways that models could not explain. Economists could not make head or tail of Japan's strange economy.

{p. 93} Revenge of the Nerds

However, the "Goldilocks" "new economy" did not last. **Economists were startled again when asset prices tumbled from 1990 onward**. Between January 1990 and December 1994, stock and land prices halved. Many **companies and individuals who had borrowed money to purchase land speculatively found themselves unable to service their debts, let alone repay the principal**. Corporate and individual bankruptcies soared to postwar highs. **Japanese investors pulled out of their overseas investments in a stampede**. Previously unheard of, several Japanese banks and securities firms became insolvent. The boom of the 1980s turned into **the bust of the 1990s, the biggest economic slump since the 1930s**.

Some economists seemed relieved. The downturn was evidence that, after all, Japan's economic system was not so successful. **What had previously been praised about Japan - the close ties between the government and the private sector**, the monitoring by main banks, the family-style corporate system - **were suddenly nothing but cronyism, corruption, and lack of transparency**. The system was quickly blamed for the recession. Both inside and outside Japan, voices began to call for a reformation of the Japanese economic structure, as already happened in the 1970s. However, this time the voices did not recede for a decade.

Money Is the Answer

Japan's structure is not responsible for the bubble of the 1980s or the slump of the 1990s. **Traditional theories could not explain Japanese asset prices, because they neglected the role of credit creation**. From about 1986 onward, **banks increased credit creation**

aggressively. Loan growth of the city banks averaged about 15 percent in the late 1980s, and total loan growth remained above 12 percent most of the time. Meanwhile, **the ability of the economy to service these loans - national income - only grew about half as fast**.12 It was a classic case of unproductive excess credit creation: **money was produced by the banking system but not used productively. Instead, it was used for speculation or conspicuous consumption.**

As more **money was created out of nothing and injected into the real estate market to buy land, demand for land rose**. Since the supply of **land is fixed, land prices had to rise. This created capital gains for the speculators**. And that attracted even more speculation.13

Seemingly Safe and Sound

The rising land prices further encouraged the bankers to lend. Especially since the banking crisis of 1927, the Japanese banking system has relied on collateral, and this has almost always meant land collateral.14 Large firms belonging to the same business groups as the banks could receive loans without security. But the majority of borrowers could obtain loans only if they could also put up land as collateral.

{p. 94} In that case, banks hardly cared to ask what the loans would be used for. The alternative method, widespread in the United States, was to calculate the expected cash flow of the proposed investment project. However, Japanese banks considered the cash flow projection method too risky. How could bankers assess correctly how many goods a company would be able to sell?

Banks preferred the collateral method, as it was simple. **The loan officers checked the annually published official land prices of each area, the *rosenka*, and then lent up to 70 percent** of this market value. The 70 percent rule was imposed on banks by the Ministry of Finance, which wanted to provide a safety margin. Even if land prices dropped by 30 percent, there would be enough collateral to cover the entire loan.15

The land collateral principle fitted into the designs of the **policymakers** who **were directing credit toward strategic industries and did not want consumers to be able to borrow money**. Most land holdings in the big cities have been in the hands of large firms, and this helped them raise funds. As city center land prices soared, companies were assured of an ever-increasing flow of liquidity from banks. Throughout the postwar era, land had therefore been a pillar of the Japanese financial system.

Land prices climbed steadily for much of the postwar era. There were interruptions, such as after the bubble of the early 1970s, when land prices dropped. But to the generation of loan officers on the job in the mid-1980s, it seemed as if land prices could not fall. Many economists encouraged them in this view, arguing that demand for land was likely to rise: In the 1980s, globalization and internationalization were key buzzwords and foreign financial institutions expanded their operations in Tokyo. They needed office space. Moreover, as the speculative frenzy took off and more financial firms were founded, demand for land in central business districts was boosted. Since **most forecasters simply project current trends into the future**, real estate analysts predicted a continued rise of land prices right into the next century.

A classic bubble had developed: Rising prices led to further investments, which pushed up prices even more. However, it was not based on economic fundamentals. **Like all bubbles, it was simply fueled by the rapid creation of new money by the banking system.**

The Fallacy of Composition, Again

Individual loan officers could hardly have seen the danger: They considered land prices as a given variable, one they could not hope to influence. Thus they extended loans on the basis of it. But as all other loan officers did the same and stepped up lending for real estate purchases, land prices were driven up. Banks, therefore, suffered from the fallacy of composition. **Each bank considered land as safe collateral without realizing that the collective action of banks was driving up land prices** and hence was far from safe, **depending on ever-rising bank loans to fuel real estate speculation**. Consequently, banks systematically un-

{p. 95} derestimated credit risk. Each bank thought that its real estate loans were safe. However, **as soon as the total supply of loans for real estate transactions fell, so would land prices**.16

The share of total outstanding bank loans that was accounted for by real estate speculation is striking. By the end of 1989, real estate loans had reached 12 percent of total loans of all banks. However, loans to the construction sector were equally used for real estate speculation, accounting for another 5.4 percent of total outstanding loans. Further, many companies and banks had set up nonbank financial institutions that borrowed money from banks and then lent it to real estate speculators (another 10 percent of total loans). In total, "bubble" loans already summed up to 27 percent of total loans, an absolute sum of 98.9 trillion or 25 percent of 1989 nominal GDP. In the late 1970s, the share of these three "bubble" sectors was only 15 percent, or 9.9 percent of nominal GDP.17

In reality, there was more. **Many loans officially classified as lending for other purposes were in actual fact diverted to real estate speculation**. "Service sector" loans, for instance, soared in the late 1980s, and many were used for speculative investments. Even some of the straight "manufacturing" loans, officially used for operations or plant and equipment investment, had in actual fact found their way into *zai-tech* speculative investments. This meant that **far more than a third of total credit creation had been used for wasteful purposes, instead of productive investments**.18

Easy Money

Normally, banks choose clients from among a large number of loan applicants, turning down a significant percentage. From 1986 to 1987, banks were liberal in their lending attitude. But from 1987 onward, the tables had turned: It was the bankers who were aggressively pursuing potential customers. After large-scale borrowers had already borrowed as much as they wanted, **the banks actively courted even small real estate and property development firms** in an attempt to drum up more borrowers. Banks competed fiercely against each other to expand their loan books.

When banks become keen to expand their loan books, they may not be able to do much to increase productive credit creation. That is determined by the fundamentals of the economy, namely, the quantity of factor inputs (land, labor, capital, technology) and the quality of their use (productivity). But banks can increase unproductive credit creation almost at will. All they need to do is give borrowers the prospect of substantial capital gains. This can be done by focusing on collateralized loans - loans where an asset class, such as land or stocks, is used as a rationing and credit allocation device. By raising the ratio of the loan value to the valuation of the land, banks attract more borrowers who think they can make a profit. As the banks raise the appraisal value of collateral, its price is pushed up, thus providing capital gains to the borrowers and rendering their investment profitable. Both banks

{p. 96} and borrowers feel encouraged to engage in further such activities, and as word gets around, more and more individuals and companies want to join the game.19

This is what the loan officers at Japan's banks did in the late 1980s. **Instead of the current *rosenka* land values, loan officers anticipated the land value of the next year** - for instance, by assuming the repetition of the price increase from the previous year. So while the official loan/valuation ratio stayed at 70 percent, their "estimate" of the valuation had risen such that borrowers could receive 100 percent or more of the current market value of land collateral. Soon even this was not enough. Loan officers started to employ the estimated land value two years on. Banks made increasingly exaggerated assessments of the land value, so that the actual ratio of land value to loan often jumped to 300 percent or more.20

Anecdotes abound about how banks were soliciting loans at bargain interest rates, **pursuing clients like street peddlers**. For instance, the owner of a small real estate development company reported how in late 1987 he had been visited by a branch manager of a major city bank with which he had previously had no business dealings. The branch manager did not just offer his services, but literally urged the man to borrow money from the bank. Whatever interest rate he wished to pay, the bank would agree to, he was assured. "Please, just borrow money, and don't even think about the interest rate and payment schedule," the branch manager told him. When the business owner retorted that he did not need money, the branch manager pulled out information about a specific real estate project that had been identified by bank staff. The branch manager explained that there was a piece of real estate in a shopping area of Tokyo that could be bought for 600 million. Since the banks had to stick to the 70 percent loan/collateral value ratio, they could normally only have lent 420 million to purchase this plot. But the bank drew up a sales contract for 1.1 billion for the piece of property concerned. Based on this contract, the bank then extended a loan over 770 million to the real estate developer. While the 70 percent loan valuation ratio was apparently maintained, in actual fact it was far beyond 100 percent.2l

There are other documented cases where bank loan officers, pressed hard by their superiors to extend more loans, actively searched for potential borrowers and offered to generously fund the speculative purchase of a piece of land - already chosen and its value "estimated" by the loan officer - with "guaranteed" capital gain.

Banks quite clearly were desperate to get rid of their money. To the layman, this was a strange phenomenon. **People soon dubbed it "*kane amari*" (excess money). Only economists, analysts, and those working in the financial markets or for real estate firms knew better**. They dismissed such a simplistic analysis. Land prlces were going up due to far more complicated reasons than just excess money, they claimed. Ordinary people simply did not understand the intricacies of advanced financial technology. **The experts, who had studied finance and economics at university, knew that market prices were always right and therefore land prices were justified.**

{p. 97} The Classic Credit Bubble

The ordinary man in the street turned out to be wiser than the experts. *Kane amari* was an accurate description of what was going on. Banks gave out too many loans and hence created too much money. **The money was not mainly used for consumption, thus consumer prices remained modest**. It was used for financial transactions, thus creating asset price rises - **asset inflation**, or what is now called the "bubble."

Just as in the early 1970s, individual banks did not recognize that they were collectively pushing up land prices. It was the same process that fueled the real estate boom in Scandinavia in the 1980s. **It also fueled the mortgage lending and house price boom in the United States and United Kingdom in the 1980s**. The same process also created the "golden twenties": In the 1920s, U.S. banks lent with stocks as collateral. The principle remained the same. As each bank took the stock price as given, it created new money for stock transactions. With more money in the stock market, stock prices had to rise. Each bank thought it was safe accepting a certain percentage of the value of the stock as collateral, but the actions of all banks together drove up the overall market. More and more money was created. **The same bank-driven credit boom was at work in the 1990s in Korea, Thailand, Indonesia, Malaysia, and**, of course, also **the United States**. It is invariably the same story. And what happens after a credit boom is also always the same: a credit bust, a banking or financial crisis with scandals, and a recession.

Disaster Looms When Debt Rises Faster than Income

Bank loans can be called the borrowing of the nation. The ability to service loans depends on income generation. That is GDP growth. The visible problem was that in the late 1980s, Japanese bank loans grew by double digits, while nominal GDP rose by no more than 6 percent.22 **Loan growth in excess of GDP growth is one approximation of unproductive credit creation**. All this money was not used to create more national output, but to play the land and stock markets, creating nothing but debt. Given the extent of credit creation, it was not difficult to conclude that Japan was heading for disaster. Whether one considers an individual, a company, or a country, if total borrowing rises faster than income is growing, at one stage the borrower will not be able to pay back all those loans.

Asset prices rise only as long as new money enters the market. **All it takes to burst a credit-driven asset bubble is for loan growth to slow**. Then the whole credit pyramid must collapse like a house of cards. Asset prices would fall. That would leave many speculators heavily exposed, for they need asset price rises to service their loans, let alone repay them. Thus they are forced to sell the asset. As more speculators sell, asset prices fall. More speculative borrowing schemes unravel. Many speculators are driven into bankruptcy. That creates large bad debts for the banks. In aggregate, it is easy to estimate the ultimate scale of the problem: **When the bubble bursts, all the speculative lending must turn into bad debts.**

{p. 98} Bust: The Story of the 1990s

This, of course, is precisely what happened in the 1990s in Japan. **In mid-1989 banks suddenly restricted loan growth**. Half a year later, stock prices peaked. Then land prices stopped rising. As no more newly created money entered the asset markets, asset prices could not rise further. Speculators had to cover their positions and started to sell. **In 1990 alone, the stock market, as measured by the Nikkei 225 index, dropped a precipitous 32 percent**. Land prices also started their sharp decline. **Some highly speculative plots of land in commercial districts saw their "market value" drop by 80 percent or more**. **More and more real estate speculators became "distressed." As they went bankrupt, banks got their first taste of bad debts in decades. They realized that the problem could easily escalate. So they became cautious**. Very cautious. They drastically reduced the amount of new loans to real estate, construction, and nonbank financial firms. This, however, had to push asset prices further down, because less and less new money was coming into the market. So bankruptcies rose.

As banks began to realize the enormous scale of potential bad debt - the majority of the 99 trillion in "bubble" loans were likely to turn sour - **they became so fearful that they not only stopped lending to speculators, but also began to restrict loans to manufacturing firms** that had nothing to do with the bubble.

The Credit Crunch

The Japanese wartime and postwar corporate system with its subcontracting relatlonships is built like a corporate hierarchy, with a small number of large firms at the top and a large number of small firms at the bottom of the food chain. The small and medium-sized firms are too small to issue corporate bonds and are therefore entirely dependent on bank loans for their external funding. Not surprisingly, they have remained the biggest customers of the banks, despite the inroads made by speculators in the 1980s. The snag is that **lending to small firms is always riskier than lending to large firms**. So in the early 1990s, when banks became burdened with bad debts and more averse to risk of default, they **reduced their lending to small firms**. From 1992 onward, small firms suffered trom a credit crunch.3

The implications for the economy were enormous: **Small firms are Japan's number one employer, accounting for 70 percent** of total employment. The impact was immediate, because **small firms never had the luxury of lifetime employment and seniority pay**. These structures had been reserved by the war economy bureaucrats for the larger firms. In recessions the small firms quickly reduce bonuses and pay, and they lay off staff. Since they are the main employer in Japan, actual **unemployment started to rise from 1992 and disposable incomes dropped**. As employees of small firms quite rightly started to worry about their jobs, they **spent less and saved more**. As consumption slumped, companies could sell fewer of their products. Yet

{p. 99} they had just finished new factories and expanded their production capacities. Inventories of unsold goods piled up. Prices were driven down. Even the large firms had to start cost-cutting measures. Labor markets worsened further. In short, Japan was in a full-blown recession.

That was predictable. With paralyzed banks reducing loan growth, total credit creation in the economy shrank. Less purchasing power was available. Consequently, GDP growth had to slow drastically. Thus, from 1991 onward, Japan's economy slid into the longest and deepest postwar recession since the 1930s. Unemployment soared to postwar records. Probably more than five million Japanese lost their jobs and did not find employment elsewhere.

Again, most **economists were puzzled. They had not predicted an economic slump. To the contrary, as the official discount rate was reduced** (nine times altogether since 1991), **they predicted an economic recovery**, believing that interest rates were a good predictor of economic growth. When this author warned in late 1991 that Japanese banks would be driven to the brink of bankruptcy and a massive credit crunch would produce a major recession, the established experts dismissed the prediction.4 How could Japan, which was seemingly taking over the world, whose exports had conquered global market shares, and whose money was buying up assets around the earth, suddenly fall into a full-blown recession?

The recession also lasted longer than expected, for the simple reason that **economic growth takes place only when there is more credit creation**. Falling interest rates did not help as long as credit creation remained small. Yet as late as 1993 and 1994, most economists in Tokyo denied that there was a credit crunch. Their theories simply did not include **credit creation, the very process that is at the heart of every economy.**

Mysteries Solved by Credit

Credit variables tell a simple story. Figure 9.1 shows **bank lending to the real estate sector and land prices.** As can be seen, there is a high correlation (which is also confirmed by statistical tests).5 Credit also explains why the traditional money supply measures did not have much of a link with GDP anymore. **Money was increasingly used for transactions that are not part of GDP** at all, namely, **speculative financial and real estate transactions**. We should expect nominal GDP growth to be closely correlated only with that part of credit creation that was used tor GDP transactions. In other words, we should expect **total loans minus the three bubble sectors** - real estate, construction, and nonbank financial institutions - **to be closely correlated to nominal GDP growth**. Figure 9.2 shows that this is indeed the case. Our index tor GDP-based credit creation explains not only the boom years of the 1980s but also the sharp collapse in GDP growth from 1991 onward.6

Finally, our credit model also explains the mystery of Japanese foreign investment that swept across the world in the 1980s and collapsed in 1991: **Japan simply printed money and bought the world.**

{p. 100} Figure 9.1 Bank Lending to the Real Estate Sector and Land Prices

Figure 9.2 Credit Creation Used for GDP Transactions and Nominal GDP in Japan

{p. 101} **While it is illegal for individuals to print money and go on a shopping spree, central banks have a license to print as much as they wish**. Yet it is not easy for a country to just print money and then go shopping all over the world. **To buy foreign assets, domestic**

currency must be converted. Under flexible exchanges, foreign exchange dealers would observe unusually strong demand for the foreign currency - say, the U.S. dollar - and a large supply of the currency of the country concerned. **This would immediately affect exchange rates**. In addition, foreign exchange dealers keep an eye on key economic indicators of the countries whose currency they deal in. **If there was high inflation in a country, this would be seen as evidence that the central bank was printing too much money. So the value of that currency would fall.**

There is a snag. The currency of the country that is printing too much money does not weaken automatically. Foreign exchange dealers act on information they receive, and this affects exchange rates. So **if the traditional indicators that the dealers watch do not pick up the excess money creation in the country concerned, and if the country has a current account surplus, so that there is demand for its currency** (because it is selling its products successfully to the world), **then printing a lot of extra money and trying to exchange it for U.S. dollars might work**. A neat financial trick could be pulled off: The country can just print money and buy foreign assets. Economists call the phenomenon in which prices do not reflect monetary changes "money illusion."

Yen Illusion: Japan Printed Money and Bought the World

What happened in the 1980s in Japan may be one of the biggest bouts of money illusion ever witnessed. Not only did domestic investors and bankers suffer from money illusion, but so did the rest of the world. Effectively, **Japan printed money and went out to buy the world.** The **usual measure of inflation is the consumer price index**. As we have seen, though, the excess credit creation was **not used to buy goods and services**. Most of the excess money went into financial transactions, producing **asset price inflation. Thus the CPI remained stable**, growing 1.3 percent on average in the second half of the 1980s. The overall WPI, thanks to declining prices of imports, actually fell, on average, 2.7 percent in the second half of the 1980s, having grown 2.3 percent in the first half.27

Any suggestion that the soaring capital outflows were connected to the Japanese bubble was dismissed by leading economists. They argued that high land prices could not possibly affect capital flows: When the Japanese sold their land, they sold mainly to other Japanese. This would therefore not increase their overall ability to invest abroad, as the seller of the land would have more money but the buyer would have less - a zero-sum game.28 In actual fact, **land prices were driven up by excess credit creation. This extra money could also spill abroad**. In practice this could take the direct route of a large Japanese real estate developer borrowing from a Japanese bank and buying prime real estate in Hawaii, California. New

{p. 102} Figure 9.3 Net Long-Term Capital Flows and Bank Lending to Real Estate Firms

York, or elsewhere. It could also take an indirect route: The excess credit creation boosted the assets of financial institutions, such as life insurers. Having more money avallable, they had to invest more. Portfolio diversification implied that foreign assets should also be bought - from real estate to U.S. Treasuries or whole foreign companles.

We would therefore expect that **Japanese foreign investment should be proportionate to speculative credit creation**. Figure 9.3 plots Japanese foreign investment against real estate loans. As can be seen, there is a close correlation, quite unusual for such volatlle financial data. Japan created new hot money and then bought up the world. **Despite the enormous capital outflows, the yen did not weaken**. To the contrary, **it rose 106 percent from 1985 to 1987**.29

Japan had pulled off the same trick that the United States had used in the 1950s and 1960s, when U.S. banks excessively created dollars. Corporate America used this hot money to buy up European companies. While the United States had the cover of the dollar standard, **Japan's cover was its significant trade surpluses, which convinced observers that the yen had to be strong**. As the yen did not weaken, the world suffered from the biggest bout of money illusion on record - the Great Yen Illusion.

[p. 103} 10 How to Prolong a Recession

Seven Lean Years

By mid-1995, Japan's recession had already lasted far longer than most economists had predicted. Analysts and investors who had been holding out for a full-blown recovery - and there were many in the first half of the 1990s - became gloomy as they surveyed the economy. The yen had risen to around ¥80/$ - unthinkable for many just half a year earlier. Exporters were under pressure, demand in the economy faltered, production growth slowed, inventories built up, and firms cut costs to stay in business. Increased competition and deregulation put further deflationary pressure on the economy. Price destruction made consumers postpone purchases as the layoffs pushed up unemployment to a new postwar high. Meanwhile, the banking system was weighed down by bad debts.

Unexpected by most observers, the economy staged a sudden recovery in 1996, growing by around 4 percent. But this was not sustained: The economy slumped again in 1997 and 1998. It seemed to take the yen with it this time. It collapsed to nearly ¥147/$ on June 15, 1998, around 80 percent weaker than its peak in April 1995. Yet the weak yen did not help the Japanese economy. To the contrary, most analysts now considered it as a sign of weakness and of capital flight from a country that seemed headed toward economic meltdown.

Attempts by the authorities to stimulate the economy had been to no avail: The downward spiral was accelerating and had turned into a vicious cycle of contracting demand, falling prices, squeezed companies, and further contracting demand. Few economists thought about recovery.

Yet most observers were once again surprised by a sharp recovery of the economy in 1999 and a more than 50 percent rise in the Tokyo stock market. But the stock market peaked in the first quarter of 2000 and both market and economy slumped once again in mid-2000 and 2001. By early 200, most commentators had given up hope of a speedy recovery. There had been too many false starts. Each time the economy recovered, it seemed to sink back into recession soon after.

{p. 123} When the **BoJ was told by the MoF to buy U.S. dollars**, it went ahead and did so. **MoF perhaps assumed that the BoJ would print the yen** needed to buy U.S. dollars or U.S.

Treasuries and **thus that the yen would weaken**. But this is not necessarily the case. In simplest terms, the **BoJ sold government bonds** or other paper to investors in the domestic economy **and used the proceeds to** implement the **foreign exchange intervention**. **Instead of printing the money, it took it from the economy**. Economists call such an operation **"sterilization"**. Since the BoJ's credit creation did not rise under such a policy, the yen will not weaken.

In February and March 1995, when MoF ordered the BoJ to buy U.S. 20 billion worth of U.S. paper, the BoJ **"oversterilized" by withdrawing more money** from the economy than was needed for the foreign exchange intervention ordered by MoF. Net credit shrank in March 1995, and the yen shot up to its record high.

A replay of the battle between MoF and the BoJ over the yen exchange rate occurred in 1999. Haven fallen dramatically in 1998, the yen was widely expected to remain weak in the following year. However, the Bank of Japan **withdrew credit from the economy at a record pace**. This credit shrinkage strengthened the yen to close to ¥100/S by the end of 1999, despite new record foreign exchange interventions ordered by MoF. The Bank of Japan **again oversterilized** them.

... {Go and buy the book: new at http://www3.addall.com ; second-hand at http://dogbert.abebooks.com/abe/BookSearch?an=richard+werner&tn=princes+yen}

{p. 170} The Maekawa Report

{In the pages to come, remember the US pressure on Japan to engage in more reciprocal trade; on p. 177 below, Warner writes, "**The goals pursued by the princes were virtually identical with the goals demanded by the United States**. **American pressure on Japan to change its system mounted from the late 1970s onward**."}

After ten years in charge of monetary policy, Haruo "Mike" **Maekawa handed over the control levers of the economy to Mieno** in December 1984. As Sasaki had done before him, this enabled him to engage in lobbying and more open scheming in the pursuit of his goals.52 The lobbying of **Sasaki and Maekawa, as well as other like-minded internationalists**, was not without impact. On October 31, 1985, Japan's prime minister, Yasuhiro Nakasone, formed the Study Group on Adjusting the Economic Structure for International Cooperation, officially translated into English as the Advisory Group on **Economic Structural Adjustment for International Harmony**. Nakasone appointed Maekawa to head the group with the brief to "conduct a study on policy measures, from mediumto long-term perspectives, concerning Japan's economic and social structure and management" and how it should change. Over the coming five months, the Advisory Group met nineteen times, and on April 7, 1986, it submitted its recommendations to the prime minister.53 In the media, the report quickly became known by the name of the chairman who had shaped its content and conclusions - Maekawa. While the Maekawa report received far more media attention, it closely echoed the demands of the earlier Sasaki report. It was, however, more detailed in its recommendations and blunter in its language.

In the opening paragraphs it stated its conclusion: "*The time has thus come for Japan to make a historical transfornnation* in its traditional policies on economic management and the nation's lifestyle. There can be *no further development for Japan without this transformation*" (italics added).54 The medium-term national policy goal propagated by the report was the "determination ... to attain the goal of steadily reducing the nation's current account imbalance." It was recognized that **the "large current account surplus is basically linked with Japan's economic structure" and its export orientation**. Therefore, "there is an *urgent need for Japan to implement drastic policies for structural adjustment and to seek to* ***transform the Japanese economic structure*** **into one oriented toward international cooperation**"(italics added).

The report read like a wish list by U.S. trade negotiators. It started with the call for administrative reform - basically the **abolition of bureaucratic powers** by **switching from regulation and the license system toward policies based upon market mechanisms** and to "freedom in principle, restrictions only as exceptions." It aimed at **import expansion, greater market access for foreigners**, and a "thorough promotion of deregulation." Even concerning the politically sensitive **agricultural sector, the report called for an opening up to imports** and "greater use of market mechanisms."

Maekawa's report called for the "transformation from export-led economic growth to domestic, demand-driven growth by expansion of domestic demand." This was to be achieved through **increased private consumption as well as a shift of low-value-added factories abroad**. Consumption was to be stimulated by income tax cuts, more free time through **reduced working hours**, the five-day work-

{p. 171} week, and a greater use of **paid leave for longer periods**. Consumption was also to be boosted by housing policies and urban redevelopment, based on tax incentives, relaxation of residential development guidelines, and **easing of restrictions on building size and land use**. In order to **"encourage imports of manufacturing goods"** Japan should streamline its distribution mechanism and review the "various restrictions pertaining to distribution and sales." It also called for the government to **deal harshly with unfair or exclusive trading practices**, "promote the liberalization and internationalization of the nation's financial and capital markets," and internationalize the use of the yen.

Prince Mieno Recruited for Maekawa Report

In short, the goal was a "transformation" of the entire body politic, the **abolition of the war economy system, and the introduction of a U.S.-style free market economy**. In the words of the report: "It is imperative that *every effort* be made for attainment of this national goal, and the Group thus very much hopes that the Government will make every effort to implement these recommendations with the full understanding and support of the entire nation" (italics added). Maekawa's advisory group recruited the ruling prince, Deputy Governor Mieno, as a member, while some of those members who uttered dissent, such as the highly respected economist Isamu Miyazaki, were relieved of duties.55 In **May 1987, a new, updated Maekawa report** was announced. This report had been expanded from eleven pages to forty-one and basically reiterated the points of the first report but included a much more detailed set of concrete changes that Japan should undertake. Moreover, it included some estimates how **the economy was expected to shift away from the agricultural and manufacturing sectors toward the knowledge and service industries**. Intriguingly, it also set a timetable for the completion of its goals: The knowledge and service industries, for instance, were expected to account for 32 percent of GDP in the year 2000 - up from 25 percent in 1985. It also presented calculations on the number of jobs that would be created thanks to deregulation in the new sectors. A third version of the report was announced in June 1988. It was entitled "The New Economic Plan - **The Japan that Lives Together with the World**." The explicit timetable of achieving set targets for a structural transformation of Japan by the year 2000 was further emphasized by the unofficial name of the Maekawa reports. Since their publication, the set of Maekawa reports had been known inside the Bank of Japan simply as the "ten-year plan."56

Using Monetary Policy for Structural Reform

The reports in the press and by commentators on the Maekawa report were highly critical. Observers recognized the radical nature of the plan. Thus it seemed far too ambitious It was calling for a wholesale revolution of all parts of the Japanese

{p. 172} economic, political, and social system. It seemed utopian to think one could solve the deep-rooted and intractable problems of the structural trade surplus, high land prices, the closed agricultural sector, the low quality of life, long working hours, and too much regulation all at the same time. Not surprisingly, at the packed press conference where the Maekawa report was announced, disrespectful foreign journalists gave Haruo Maekawa a difficult time: "We've heard this so many times before," one German reporter said. "Why should we believe it now?"57

Although the plan was fairly clear about what was wanted, it was **embarrassingly silent about how the proponents were going to go about achieving those lofty goals**. The only statement it contained about how to reach these goals was this: "*In the implementation of these recommendations,fiscal and monetary policy has a significant part to play*"(italics added). This is an intriguing statement, because fiscal and monetary policy are largely cyclical policies, while the report was all about structural change, something that has to do with regulations, changes of laws, and practices - in other words, a political process aimed at changing the regulatory and hence institutional framework. True, fiscal policy can have significant structural features, so its mention can be justified. Indeed, the report called for fiscal reforrn, including **abolition of preferential tax treatment for savings**. What remains unexplained, however, is how the purely cyclical policy tool called monetary policy could be used to implement structural changes. The report merely says the following to clarify this mystery: "While ensuring currency stability, ***flexible management of monetary policy*** *is necessary* to realize an economy led by domestic demand" (italics added).

There it was again - the enigmatic demand by central bankers, such as Sasaki, to implement structural changes through **"flexible" monetary policy**. "Flexibility," according to the Oxford English Dictionary, means "easily changed to suit new conditions." The time scale envisaged by the report was long, but with an immediate start: "Since the process of reforming the economic structure and improving the basic character of our economy is a long-term one, efforts to this end should be made *continuously and form a long-term perspective*. However, *relevant policy must be initiated as soon as possible*"(italics added).

The Round of the Twelfth

This raises two questions: Just what is the "relevant" form of "flexible" monetary policy that would further the structural transformation envisaged in the Maekawa report? Second, how could Maekawa hope to implement whatever this relevant flexible monetary policy was, considering he was out of power as governor? We begin by assessing the second issue did Maekawa have any influence over monetary policy?

Maekawa may have formally been out of power. But he was no outsider. As *sempai* (senior) and **mentor of the current de facto head of the Bank of Japan,** Yasushi Mieno, he had direct access to the powerful extralegal window guidance

{p. 173} credit controls. **Maekawa held exclusive meetings with Bank of Japan staff on a frequent basis**. Every twelfth of the month (with the exception of weekends and holidays), Maekawa gathered current Bank of Japan officials of the rank of board director and department head in the Hotel Okura in Tokyo. They could participate only if invited. Upon arrival, they were asked to report on their current activities and their policies at the Bank of Japan. Maekawa then gave them advice on what to do. It was an honor to be invited to this exclusive gathering with "Mike," called the "Round of the Twelfth." And since the loyalties of the princes go back decades, his precious advice was probably heeded by Mieno and his colleagues.58

Remote Control

There were other meetings. An even closer circle of Maekawa followers met on the first Monday of the month - the "Monday Club." The most frequent attendees were Mieno and Fukui - the latter by 1986 head of the Business Department and long anointed as the next prince and Mieno's successor. Every two months, Maekawa gathered a yet more select circle of followers to the Hongoku kai, named atter the address of the Bank of Japan in Hongoku-cho, Nihonbashi. Of course Mieno was there, as were selected executive board directors, such as Kanno. It goes without saying that neither Satoshi Sumita, the reigning governor of the Bank of Japan, nor other Ministry of Finance executives were invited.59

This is strong evidence that Maekawa kept closely in touch with the affairs at the Bank of Japan. However, could he actually influence events at the central bank, such as the secretive window guidance? There is evidence that Maekawa's influence even over minute details at the Bank of Japan remained significant. His power over his juniors and followers extended to personnel decisions, since **it was Maekawa who basically decided into which companies the BoJ bureaucrats, once retired from the Bank of Japan, would parachute for their *amakudari* jobs** - one of the most important, if not the most important personnel decision, since the pay structure at Japanese bureaucracies is such that payoff time arrives when a retirement job is taken. The following facts were provided by an investigative journalist of the *Nikkei Financial Daily*: Akira Oka, who had been Executive Director at the Bank of Japan, had just been made deputy governor of the Japan Development Bank. But Maekawa was looking to appoint a loyal follower to fill the post of president of the Tokyo Bay Road Company.60 So he asked Oka to resign from his new post at the Japan Development Bank (JDB) to take this job. "Once you have reached a position like yours, you can't just decide about your life on your own," Maekawa had told Oka. "So, having been told this, I had no choice," reflected Oka later.61 By having power to allocate the plum retirement jobs, Maekawa was in a strong position vis-a-vis his juniors at the central bank.

We don't know, of course, what exactly Maekawa had to discuss with the current elite of Bank of Japan executives. We do know, however, that he was keen to get them closely involved with his ten-year plan, for he took the official step of

{p. 174} formally enlisting his chosen successor, Yasushi Mieno, into the advisory council for the second Maekawa report. **Mieno was at the time officially deputy governor of the Bank of Japa**n and the ruling prince (needless to mention, the official Bank of Japan governor, **MoF's Sumita**, was not part of the Maekawa report advisory council).

Not only was Mieno the highest-ranking **trueborn** Bank of Japan official, but he, together with his chosen successor, Fukui, controlled the window guidance. We must therefore consider it as established that those who produced the Maekawa report and its timetable of transforming Japan by 2000 also had direct access to the most powerful economic policy tool, the window guidance credit controls.

Needed: A Crisis

Thus we move on to the first question. How could Maekawa and his confidants implement the Maekawa report and achieve its numerical targets by about 2000? And what was the role of the right type of ("flexible") monetary policy, which they had hinted at cryptically? We saw above that the head of the department that implemented window guidance credit controls, Toshihiko Fukui, had said in July 1987, soon after the publication of the second Maekawa report, that suitable central bank policy to implement the structural transformation of Japan's economy was to "continue with the monetary easing policy" and, explicitly, for "bank loans to expand."

Another riddle. **Why did the Bank of Japan leadership consider the excessive extension of speculative loans in the second half of the 1980s as the right monetary policy,** in order to implement Maekawa's structural transformation of Japan's economy? **Why did the very same leadership** (of Fukui and Mieno) **consider the recessionary credit policy of the 1990s as the right monetary policy** to further the plan to transform Japan's economic structure? How can the disastrous monetary policy of **first creating a bubble and then a massive recession** be considered appropriate by Fukui and Mieno?

The reformers wanted to rid Japan of the war economy structure and transform its economic system, together with the structure of political decision making (by disenfranchising the ministerial bureaucracy that had previously been dominant in shaping the regulatory framework). As their talk of a "transformation" indicated, they were aware that this was nothing short of a revolution. Why are such revolutions never easy to implement? Because any system has groups that benefit from it and hence have no desire to change it. Maekawa and friends therefore would have to overcome all the economic and political vested interests of the old system. The politicians were happy with the way things had been - they received lush funding from big business and the Finance Ministry for pork barrel projects in their rural constituencies. Big business was doing fine - huge profits were accumulating from the successful export drive that had conquered world markets. And finally, the entire power base of the bureaucracy was built on its ability to conduct administrative guidance and grant licenses. The Ministry of Finance in particular, pinnacle of

{p. 175} the bureaucratic elite, stood to lose heavily from the proposed financial deregulation program.

Given these odds, it is understandable that the media reacted negatively to the publication of the Maekawa report. Surely such a tall order was a nonstarter. More hot air from Tokyo, the foreign journalists thought. True, there were many influential leaders who shared **the internationalist perspective** - in politics, in business, and even among the bureaucracy. But they were clearly outnumbered. Even if some members of the elites could be won over by the rational arguments presented in the Maekawa report, the majority, especially those less interested in the benefit for foreign countries, could not be expected to agree **to scrap Japan's economic system - the very system that had delivered the postwar economic miracle**. The revolution was likely to fall on deaf ears.

{Yet Gorbachev had pushed such a revolution through in the Soviet Union}

Historians would not be surprised at such obstacles. It is one of the laws of history that there is only one set of circumstances under which countries ever change in a fundamental way; indeed, there is probably no country in the world that has changed its economic, social, and political system in a significant way without a crisis. Since any system breeds vested interests, change tends to come about only when a crisis shakes up the entire nation and undermines the position of the established powers.

The Maekawa report was not detailed about the "significant part" that monetary policy would play in the implementation of its goals. How could Mieno, Fukui, and their followers inside the Bank of Japan "initiate the relevant monetary policy" immediately? We saw that the Bank of Japan is a believer in this law of history, since a Bank of Japan official said, "It is not easy to change the institutional framework and promote structural reform since it necessarily involves the vested interests of all the related individual economic agents."62 Except if there is a crisis. Is this where central bankers can be helpful? In 1993, when the recession had already started (triggered by window guidance), **Mieno pointed out that thanks to this recession everyone was becoming "conscious of the need to implement such transformation,"** as the Maekawa report had envisaged. **This is from the person who was responsible for the window guidance that created the bubble**, and who indicated in 1993 that he knew very well that such a bubble must be followed by a significant downturn.

The Crisis That Window Guidance Could Create

If one wanted to implement the Maekawa report, had the necessary tools at hand to manipulate the economy, and had a Machiavellian bent, one might start thinking about how a crisis could be created.

By 2000, I was not the only observer who had concluded that "the BoJ wants to use monetary policy to induce structural reform."63 If the Bank of Japan wanted to use the cyclical tool of monetary policy "flexibly," starting "immediately" in

{p. 176} 1986, to achieve the long-run implementation of the structural transformation goals of the ten-year plan, as Bank of Japan spokesmen told us, logic leaves only one way to do this. Monetary policy would have to be used to promote a historic crisis, sufficiently large to overcome the vested interests (notably the Ministry of Finance).

Of course, such implementation would be impossible if monetary policy was transparent and worked through interest rates, but this was not the case. What type of window guidance would achieve the long-term goals best? There are only two options: one, to tighten window guidance drastically to create an immediate downturn; the other, to loosen it dramatically to create a financial bubble. One problem with the former option is that if one simply restricted window guidance without any good reason and thus created a recession, there was the danger that the cause of the recession would quickly become public knowledge (as actually happened with the tight window guidance of 1989). Opponents would complain about the excessive tightness of window guidance, and it would become difficult to tighten further. In the 1980s, the Bank of Japan still had to consider the opinions of its political opponents and **the Ministry of Finance, because legally it was completely subordinated to the latter**. The second problem would be that a sudden tightening would create a recession but would probably be insufficient to create a crisis of sufficient scale and length to discredit the old elites and force the type of historic structural transformation Maekawa, Mieno, and later Fukui, Yamaguchi, Hayami, and their colleagues talked about. Finally, **the Ministry of Finance had just committed itself to** lowering interest rates and **stimulating the economy at the Plaza agreement**. Thus the option to loosen window guidance drastically was really the only feasible one to implement the ten-year plan. It also offered the additional benefit that any criticism or leaks by bankers, central bankers, or journalists (as happened, and as we recorded) could be talked down easily by explaining that window guidance had to be consistent with MoF's policy of low interest rates.

Deductive logic therefore forces us to conclude that the only way monetary policy could have been used "immediately" in the 1980s to work toward the achievement of the transformation of Japan by 2000 involved the second option: to use window guidance to create a speculative bubble. There would be no political opposition to this move, and hence there would be no resistance to the creation of the ensuing crisis. By opening the monetary taps and flooding the economy with money, even the opponents of change would initially do so well that they would not complain. The easy money would effectively buy them. During the bubble period, corporate profits soared, real estate speculators and banks made fortunes, politicians creamed off large sums as party contributions, and the Ministry of Finance was overjoyed about the unexpectedly large tax revenues. The lush funds boosted expense accounts throughout the country. The old elite of business, bureaucrats, and politicians was satisfied, thanks to the pleasures of the economic boom. Few were wise enough to see the dangers and refuse the easy money that was on offer. The result was that a massive crisis struck when the bubble was burst. Similar to the experi-

{p. 177} ence of Midas, who perished due to his golden touch, the easy money of the 1980s had a high price.

Maekawa and his princes Mieno and Fukui controlled what probably were the only levers powerful enough to change Japan. Maekawa passed away in 1989, but his successors remained in power. Mieno and Fukui first boosted borrowings of the nation so that they by far exceeded national income growth. Having created a speculative bubble, the very same princes then made sure it burst in a spectacular and shattering way. As soon as the princes closed the monetary taps, it was inevitable, as Mieno testified in 1993, that a recession would follow. Excessive credit turned into bad debts. The paralyzed banking system would then cause a credit crunch recession. As we saw, the princes could easily have ended the recession, but they did not do so. Meanwhile, all public eyes were on the politicians and the Ministry of Finance. Few suspected the role of the Bank of Japan.

Just like Hjalmar Schacht's Reichsbank in the 1920s, the Bank of Japan has acted like a "second government" in the pursuit of a political agenda of systemic change.

External Motives

There is additional information on the motivation of the princes. **The goals pursued by the princes were virtually identical with the goals demanded by the United States**. **American pressure on Japan to change its system mounted from the late 1970s onward**. First, the United States made its demands known in negotiations with Japan. In a long string of meetings and agreements, from the yen-dollar talks in the early 1980s to the Structural Impediments Initiative toward the decade's end, t**he United States demanded that Japan change its economic structure in order to open up its economy for foreign imports** and to introduce an economic system that is nominally modeled on the free market principle, as in America. The princes had always relied on direct intervention in the credit markets in order to manipulate the economy. Their continued use of window guidance credit allocation even in the 1980s shows that they very much believed in the power of bureaucratic intervention and "guidance" of the economy. Yet, since the 1980s, they also seemed to be in favor of deregulation, liberalization, and an abandoning of direct intervention in the economy.

The close match between the ten-year plan and the demands by the United States on Japan may be pure coincidence. We do know that Prince Ichimada had been selected by the U.S. occupation and had close friends in the United States. His senior, credit controller Araki, moved from being a suspected war criminal straight to the post of Japanese ambassador to the United States. They, in turn, handpicked their successors early, thus establishing deep loyalty.

While the postwar policy of the United States switched in the early postwar era to maintaining the mobilized war economy system, this had changed by the early 1980s. **The costs to the United States of the successful war economy system were**

{p. 178} **appreciating**. So the United States gave the go-ahead for Japan to change. This was no secret and was widely publicized at the time of the first yen-dollar talks. That was when Sasaki published his first plans for changing Japan. Soon afterward, his successors Maekawa, Mieno, and Fukui were all found to be advocates of the structural transformation of the Japanese economy. Some have been more outspoken in public and some less so, but **since the 1980s they have all been keen to dismantle the war economy and open up Japan** to the United States and the world.

The Prosecution Rests Its Case

What we have established is that Fukui, Mieno, and their colleagues were not insane, and that they were aware of the consequences of their actions when they created the bubble of the 1980s and when they prolonged the recession of the 1990s. Moreover, we have established that they had a widely publicized motive, and given that motive, their behavior could be explained as a rational course of action - indeed, the only one consistent with achieving their goals. In law, the judge or the jury would now look at the evidence and testimonials, deliberate, and announce the verdict. But Mieno, Fukui, and their colleagues are not in court. They are still at large. Their successors are in power. Indeed, today, as **Prime Minister** Junichiro **Koizumi has adopted the Bank of Japan's structural reform agenda as government policy**, Toshihiko Fukui is a member of the government's Financial System Council (while also being an adviser of Goldman Sachs) and, despite political resistance against him, remained a leading candidate to become central bank governor in March 2003.

In 1998, the Bank of Japan became legally more powerful, and is now virtually unaccountable. As a public institution, the Bank of Japan has responded to the raising of these issues with silence or misinformation (for instance, it still claims in public that window guidance was meaningless during the 1980s). Despite this book becoming a best-seller in Japan and being widely discussed, the Bank of Japan has not raised any objections in public to its arguments.

{p. 179} 15 Back to the Future

The Return of U.S.-Style Capitalism

Recession Ended MoF Dominance

In the late 1980s, the bright, powerful bureaucrats at the Okurasho had been considered a dream catch for any Japanese bride. The man who could introduce himself with a business card, or *meishi*, from the renowned Finance Ministry elicited deep bows and hushed exclamations of awe and respect, not only from potential in-laws but also from society at large. But times have changed for the MoF men. Scandals have rocked the ministry. In early 1998, public prosecutors for the first time actually raided the most powerful of Japan's ministries. Frequent demonstrations have been held outside the ministry's doors by citizens disgusted by the bureaucrats' actions. Several senior bureaucrats have been arrested in the past few years, and several have committed suicide. In January 2001, the Okurasho was abolished. The remaining rump is a far cry from the powerful institution that it had been for over half a century.

As a result of the long recession and crisis of the 1990s, the princes of the Bank of Japan won their decades-old war with the Ministry of Finance once and for all. Since all traditional policies to revive the performance of the old system seemed to fail, the system itself was blamed.

A number of commentators, initially from abroad, later homegrown, claimed that Japan's troubles were due to the fact that Japan did not follow the free market model. To them it was no wonder Japan was in recession, what with powerful bureaucrats setting a plethora of regulations and maintaining a cartelized and closed domestic economy, **companies ignoring the demands of shareholders for profitability, frozen labor market structures with lifetime employment**, a corporate sector burdened with debt. To neoclassical economists, the real surprise was that the Japanese system had not collapsed earlier. As the symbol of the old economy, MoF was blamed for the lost decade, the escalating fiscal crisis, as well as the creation of the bubble. It was accused of incompetence and, worse, corruption.

As a result, MoF had no more standing to defend itself. It fell prey to politicians

{p. 180} eager to gain credibility by bashing the best scapegoat about: the Ministry. By late 1996, MoF had lost the battle for regulation policy, having to concede **a full-blown deregulation of the financial sector, known as the "Big Bang."** This abolished the license system, one of MoF's main power bases. By early 1997, MoF had lost the battle again, this time for **supervision over the banking system**. It was decided that beginning in June 1998, this task would be h**anded over to an independent Financial Supervisory Authority.** In a previously unthinkable move, MoF's banking bureau and securities bureau were abolished. The new FSA began business with a vengeance in June 1998, closing two *amakudari* banks, LTCB and NCB. By late 1997, MoF had also lost the battle for political initiative, so that since then all decisions on fiscal and regulatory policy have been made by LDP politicians.

Most importantly, **MoF had lost the battle for** the key control lever, monetary policy and **oversight of the Bank of Japan**. In June 1997, a revised Bank of Japan Law was passed, which became effective in April 1998. This finally gave the Bank of Japan what it had been struggling to gain for half a century - **independence from MoF, and, for good measure, from anyone else** (more on this in chapter 18).

What if the Bank of Japan Is Right?

But we have found that the princes pursued goals much grander than just breaking up the ministry and becoming legally independent. Their goal has been the structural transformation of Japan's economy. While it is one thing to criticize the way they may have pursued this goal, **what if the ultimate goal, to change Japan's economic structure, was not so bad after all, and perhaps in the long-term interest of Japan and the rest of the world?** And if, as is quite possible, their particular monetary policies were the only way to implement this structural reform, then perhaps the central bankers have been doing the right thing all along. Certainly the press, especially the foreign press, though by the late 1990s increasingly aware of the use of monetary policy to implement structural change, seems to approve and expresses no surprise or shock that Hayami "fears that if he loosens policy too quickly, it would remove the pressure for reform."1

Leading politicians have now also explicitly adopted the old structural reform agenda and seem sympathetic to the idea of creating hardships to facilitate the reform process. **The politician whose script could have been written by the princes at the Bank of Japan is the declared**

reform prime minister, Junichiro Koizumi. At the Geneva summit in July 2001, when asked how he was going to balance cyclical and structural reform policies, Koizumi replied, "I say: 'no growth without reform.' ... Because we have decided 'no growth without reform,' we cannot postpone reform and take cyclical stimulation policies. Some say recovery comes first, without reforms. But if the economy recovers, the will to reform will disappear. ... After the elections I will continue with the plan of 'no growth without structural reform'" (italics added).2 It is noticeable that Koizumi did not claim that structural reforms are necessary for a recovery, in terms of economic causation. He had decided to declare

{p. 181} "no growth without reform," which expresses the Bank of Japan's motto of the 1990s well. It is indeed merely a restatement of a phrase in the Maekawa report, which said that Japan urgently needed "to make a historic transformation in its traditional policies on economic management and the nation's lifestyle. There can be no further development for Japan without this transformation."

Of course, it is clear that the bad performance of the economy during the 1990s is not a good reason to implement structural changes. During the 1990s, the Bank of Japan has argued that stimulatory monetary policies would be counterproductive to its long-term goal of structural change precisely because they would be effective in achieving their goal of creating a recovery. This, however, recognizes that the economy would respond to cyclical policies, and hence admits that the bad performance of the 1990s is not a reason to change Japan's economic structure. In other words, by admitting that a short-term downturn may be necessary to implement structural changes, proponents of structural reform deprive themselves of their main argument for just why structural reform is necessary. The Bank of Japan effectively agrees with many of its critics that the economy, in an unreformed state, could have produced higher growth than has been the case for much of the 1990s. If this is the case, then why does the Bank of Japan want to change Japan's economic structure?

Could the motivation of Maekawa's ten-year plan justify the Bank of Japan's actions? **It argued that in a globalized and internationalized world economy, Japan could not continue its closed, export-oriented economy**. It had to open up to the world. Equally importantly, it also argued that changing Japan's economic structure would not only **end trade friction, but also raise the standard of living** and the quality of life in Japan and boost Japan's economic growth rate. Was this claim just good salesmanship, to appease a conservative population that would resist change? Or is there some iruth to it?

Pillars of Growth

Japan's postwar modification of the war economy was hooked on success. It needed continued high growth in order to remain viable as a system. As we saw, in Japan's war economy the profit motive had been replaced by the goal of market share expansion. Shareholders received low dividends but were rewarded by rising share prices, reflecting the reinvested profits. So continued growth was necessary to keep shareholders content. The same applied to managers and employees. In the war economy system they were motivated by moving up the corporate ladder. Pay scales at large firms began modestly but rose quickly. To keep the promise of lifetime employment and ever-rising salaries, continued high growth was necessary. Finally, high and rising standards of living would appease the population, which had little political say in the system - and a lower quality of life than in Europe or America. In other words, the war economy needed high economic growth to satisfy all interest groups.

{p. 182} **Growth, however, was ultimately based on exports. Although they accounted for less than 15 percent of GDP in the 1990s, their importance had been larger**. Domestic demand had been suppressed and domestic prices kept artificially high YOY % to increase savings. **The goods that were produced with the overinvestment had to be sold abroad.**

Without continued growth, the system was unsustainable and would have to be modified at the very least. The ability to grow fast rested on two pillars. One was a world trade system (read that of the United States) that allowed Japan to **eat into everybody else's market shar**e.**In exchange for the strategic military benefits, the United States allowed the continuation of the war economy**. The second pillar was the ability to **constantly allocate new credit to productive sectors. MITI helped in their identification. Drawing on its advice, the BoJ princes allocated credit**. **Unproductive sectors could not obtain purchasing power**. This way Japan quickly moved up the value-added ladder, from textiles to steel to automobiles to semiconductors and consumer electronics.

Crisis of the Miracle Model

Both pillars of growth started to crumble in the early 1970s. Beginning **in the 1980s, when the costs of Japan's export drive became too large for the United States to bear**, all U.S. administrations have been demanding that Japan abandon its export orientation and open its markets. **With the end of the Cold War, this policy change became much more urgent**, as the political and strategic benefits of a strong Japan were also reassessed.

{during the Cold War, then, Japan was able to get away with this export-oriented drive, because the US needed it on its side against the Soviet Union}

Japan could not ignore the foreign cry for change: Suffering from Japan's trade surpluses, the world could close itself off from Japanese imports. For a long time this threat seemed only theoretical, with Japanese goods having become so dominant in many sectors that a boycott would be unthinkable. However, **the creation of trade blocs and strong Asian competitors had changed the equation**. Despite skepticism, Europe forged monetary union. North and South America are scheduled to be united in a single free trade zone in 2005, likely to be followed by monetary union some time later. Such large trade blocs could become autarkic, or at least independent from Japanese goods.

{Did the US help build up South Korea and China, to counter the rise of Japan?}

The second pillar of growth, the constant upgrading to higher-value-added activities, was also showing its age. In the past, all the new high-value-added areas, from automobiles in the 1970s to semiconductors in the 1980s, had been within the manufacturing sector. Now **Japan had reached the top of the manufacturing value-added pyramid**. Despite maximum rationalization and heavy investments, the incremental additional value produced by even the top-end manufacturers was leveling off. The growth potential of manufacturing was diminishing.

The main factor inputs that are used in an economy are land, labor, capital, and technology. The war economy system is probably the most efficient at mobilizing

{p. 183} Figure 15.1 Japanese Real GDP Growth

these inputs in the shortest possible time and ensuring that they are used for whatever activity is considered high priority. As more and more people joined the labor force, as more land was used productively, as capital investments were increased, and as new technologies continued to be introduced from abroad, economic growth remained high. However, in the 1970s, after decades of high growth, Japan was approaching full employment of these factor inputs.

Worse, the quantity of inputs started declining. The workforce participation had reached a peak and, due to an aging society, was approaching the point where it would fall. Land is fixed, and it was hard to raise its productivity (although decentralization and regionalization would provide an answer). Capital investment had reached a level where any further increases led to diminishing returns. Technological inputs were much harder to come by now that Japan's technology had caught up with that of the world leaders. **Instead of copying or licensing, expensive and time-intensive research and development was now needed**.

Japan was running out of inputs. Consequently, the war economy system could not deliver high growth anymore. Beginning in the 1970s, Japan's economic growth rate dropped sharply: While growth averaged 8.7 percent in the 1950s and 10 percent in the 1960s, it only clocked up 6.0 percent in the 1970s.3 As can be seen in Figure 15.1, statistically, Japan's growth rate has been on a sharp downward trend since. On the basis of the old reliance of input maximization in the manufacturing sector alone, economic growth would at best stagnate at the 1 percent level. The old high-growth system had turned into a slow-growth straitjacket.4 ...

{p. 185} The *endaka* (strong yen) that accompanied the tight money policy of the 1990s accompanied the **shift of manufacturing bases into Asia** and helped open up Japan's domestic economy to imports. **The unprecedented shift of factories out of the country** had virtually **created a second Japan outside its borders**. In

{p. 186} Figure 15.2 Import Share of Manufactured Goods

financial year 1995, **Japan produced more abroad than it exported from its shores**.

Simultaneously, **the strong yen boosted imports. A large part, of course, consisted of reimports from Japanese factories that had been shifted abroad**. However imports from Europe and North America have also soared since the mid-1980s. Japan's war economy was characterized by an unusually low share of manufactured goods among imports. The strong yen has changed that; Figure 15.2 shows that, driven by the strengthening yen, t**he share of manufacturing products among imports more than doubled** from a low 26 percent in 1980 to

64 percent in 2000, a figure that is rapidly approaching the levels seen in Germany or the United States.

The relocation of factories offshore and the influx of manufactured goods whether from Japanese overseas plants or foreign firms, forced change on the domestic economy. In order **to compete with rising imports, firms had to lower prices, reduce inefficiencies**, and increase productivity. To do that, employment practices had to change, **staff were laid off**, and consumer tastes had to be taken more seriously. New jobs had to be created at home in the new industries of the future. But thus far, domestic demand-oriented industries had been less efficient. Wlth **foreign products now gaining market share in Japan** - from semiconductors to beer, from steel to cars - **consumers would no longer be willing to pay high prices for the sake of strong exports**.

How could the domestic and service-oriented sectors be made more efficient? The same way that in the past manufacturing exporters became efficient: through competition. With the manufacturing base shifting offshore, deregulation and greater

{p. 187} import penetration became an important option to create new jobs. In turn, deregulation in one area created economic pressures for further deregulation in other areas. The effects of deregulation accumulated exponentially - painfully slowly in the beginning, but picking up speed sharply.

The Tide Turns to Transformation

In April 1995, thanks to the double crisis of economic slump and **historic yen strength**, the reformers at the BoJ, in MITI, and among the politicians managed to break the bureaucratic resistance against deregulation. The shock of the yen at ¥80/$ **convinced even die-hard conservatives that Japan had no choice but to deregulate**. Thus only weeks after the historic high of the yen, a far-reaching deregulation package was announced, consisting of a catalog of one thousand deregulation items. A "Deregulation White Paper" followed later in the year. Moreover, in 1996 and 1997, the reformers had won enough political support to push for their biggest challenge to the old war economy establishment: a full-scale deregulation of the financial sector. **The Big Bang started in April 1998 with the deregulation of the foreign exchange law**. That, indeed, symbolizes the end of the war economy, because, as we saw, it was the foreign exchange laws that began the introduction of the war economy in the 1930s.

Previously, only licensed foreign exchange banks could deal in foreign currencies. **Now foreign exchange transactions can be undertaken by anybody. Capital can flow freely into or out of the country**. The liberalization of stockbroking commissions, the blurring of the distinctions between different types of financial institutions, and the opening up of the financial sector to players from outside as well as other fields inside Japan (such as retailer Ito-Yokado) bring fierce competition with global leaders onto the home turf. All the barriers against foreign firms had come down; the doors to the domestic financial sector and hence to the entire economy are now open to the world. Hence **foreign firms took large stakes in leading Japanese firms** - unthinkable a decade earlier. For example, **Merrill Lynch took over the bankrupt Yamaichi**

Securities, the Travelers Group bought a quarter of Nikko Securities, and the U.S. fund Ripplewood bought once-mighty Long-Term Credit Bank.

Japan is shifting its economic system to U.S.-style markets, and that also means that **the center of the economy is being moved from banks to stock markets**. To entice depositors to pull their money out of the safe bank and postal savings deposits and into the risky equity market, **reformers have withdrawn the blanket guarantee on all bank deposits and propose to privatize or abolish the postal savings system,** while creating tax incentives for stock investments.

From Collectivism to Individualism

Since mid-1994, probably for the first time ever in Japanese history, **the service sector employed more people than the manufacturing sector**. Meanwhile, firms,

{p. 188} forced to boost productivity, have switched from the lockstep seniority system to **merit-based pay that could have large rewards for creative individuals**. They have adopted flexible year-round hiring. As the **educational system shifts** gear **from**being one aimed at producing human inputs into hardware production by focusing on **rote memorization to** becoming one that encourages **individuality and creativity**, the social landscape will change as well.

In 1960, **there were over one thousand legal cartels, granted exemption from the Anti-Monopoly Law. By 1998, deregulation had reduced the number to almost zero**.7 In addition to the official cartels, there were a number of special laws that had created barriers to entry in many industries. However, many of these have now been revised. The revision of the large-scale retail law boosted the number of consumer-oriented large-scale shops that are discounting heavily. In 1993, the telecommunications sector was deregulated, which created a significant boom in mobile phones and boosted employment in the information services sector dramatically. In 1996, the Electric Enterprise Law was changed to allow firms other than utilities to generate electricity. Other examples include the deregulation of the gasoline retailing law. Public prosecutors have also become tough on corporate racketeers, construction *dango* (informal collusive agreements), and other practices that the war system had brought with it.8 The Fair Trade Commission has been strengthened and made more meaningfully independent. Having previously acted in the interest of the monopolists, it seems now to be seeking to restrict their influence. Japan's new product liability law of 1995 for the first time explicitly favors consumers. In case of dispute, the burden of proof has now been placed on the manufacturer.

Political System Change

The systemic change did not stop at the economic system. The numerous scandals that followed the bursting of the bubble also brought down the 1955 system of stable one-party rule by the LDP. **In the old system, politicians did not compete by proposing different policies. Policy was made by the bureaucrats, and the politicians** merely focused on **appeasing local constituencies with public works projects**. Since the Japanese electoral law had given the rural vote a much bigger weight - up to three times that of the city vote - this meant that politicians had to please rural constituencies in particular. That gave the agricultural lobby its power over government policies. The 1993 Hosokawa administration **changed the electoral system** and thus politics, which is now **catering more to city dwellers**. Imports of agricultural products rose. **The rice market was forced open in 1993**, thanks to the government's reduction in official rice supply stocks to the lowest level on record in the postwar era. This allowed bad weather to create a rice shortage, and public opinion was influenced favorably toward the liberalization of rice imports.9

Politicians, with their **power bases increasingly in the cities and not the rural farms**, found that voters liked the idea of a higher quality of life and standard of

{p. 189} living. Thus politicians of almost all parties have since the mid-199Os been competing to present themselves as radical reformers. They have started to take power away from bureaucrats and increasingly make the key decisions. In October 1997, for the first time in postwar history, all policy initiatives to stimulate the economy originated from politicians, not bureaucrats.

The arrival of the Koizumi administration was a reminder of the popularity of the earlier reformer government under Hosokawa. By now, however, the consensus toward a deep structural transformation of Japan had become deeply engrained. Koizumi's popularity was also a much more important factor for him in retaining his position: For the first time a prime minister was in power due more to his general popularity with the voters than his support among the LDP factions.

The Ten Years That Changed Japan

Maekawa's ten-year plan effectively called for Japan's economy to revert to the freer markets that existed in Japan in the 1920s and to turn the producer economy back into a consumer economy. Thanks to the policies taken by the princes, all the main goals had been achieved by the end of the 1990s. Foremost among them, the Okurasho had been considerably weakened and the BoJ had become independent in 1998. With this, bureaucratic resistance to deregulation had been broken. But this was not all. The plan to change Japan had set in motion economic forces that continue to work today. The bubble accomplished three things: First, it taught Japanese consumers that spending money could be enjoyable. During the late 1980s, **conspicuous consumption appeare**d for the first time in postwar Japan. Though centered on the rich speculators, it took away the social stigma that conspicuous consumption had had for decades. The second result of the bubble was to send a wave of Japanese foreign investment abroad, partly to shift factories offshore. Third, the bubble set the stage for the recession, which continued the reeducation: It taught consumers newly acquainted with the joys of shopping to demand value for money. Thanks to the deflation of the 1990s, "price destruction" appeared for the first time and discounting spread widely. The recession also initiated deep structural changes in the economy, as companies were forced to lay off workers, unemployment was pushed up, and Japan's traditional lifetime and seniority-based employment system was eroded.

Striking at the Core of the War Economy System

As we saw in the early chapters, when the war economy system was established, the reduced influence of individual shareholders through diluting cross shareholdings put managers in charge and allowed them to pursue growth irrespective of dividend payments. **Firms could afford to maintain cross shareholdings even if stock prices fell, because Japan was using German-style book value ac-**

{p. 190} **counting**. Without pressure from shareholders, firms could plan for the long term and grow fast. Book value accounting had the additional benefit that it shielded companies from unnecessary volatility due to stock market movements. This contributed to overall economic stability.

This system of capitalism without capitalists had become increasingly embattled during the 1990s. The collapse of share prices and the credit crunch forced many companies to **sell off cross shareholdings** that had been created during the war and in the postwar era. That meant **the return of shareholder power**. At the same time, with Japanese equity prices on a falling trend in the 1990s, and with the Nikkei 225 index having closed at a twenty-year low on the last day of 2002, **foreign investors have seized the opportuntity to buy the ownership of Japanese companies** - something that had not been possible in earlier decades. In March 1999, **the share of stocks listed on the Tokyo Stock Exchange that were owned by foreigners reached a postwar record high of 14.1 percent. By March 2001, this had risen to 18.3 percent**, a long way above the 2.8 percent foreign ownership recorded in 1978.10 The protective structural barriers against foreign takeovers built up in the early postwar years were increasingly crumbling. **Foreign institutional investors now demand higher dividends** and better returns on assets than the old-style Japanese corporation was willing to deliver.

The Return of the Capitalists

Battered by criticism, the Ministry of Finance also agreed to adopt a radical change in Japan's accounting standards. Fiscal year 2001 was the first in Japanese history that **company books were calculated according to market value accounting**. MoF, by this time keen to please critics inside and outside Japan, was persuaded to adopt "international best practice" by **dropping book value accounting in favor of U.S.style marking to market**. It did not bother MoF that the majority of industrialized countries have not yet adopted this accounting standard, which is first and foremost a U.S. standard.

The change to market value accounting may sound like a fairly innocuous move by gray accountants. But with this seemingly harmless change in accounting rules, the bookkeepers made significant progress where decades of colorful U.S. trade negotiators had failed. **The change sharply accelerated the transformation away from the war economy corporate governance structure and toward shareholder capitalism**. Since companies and banks were made to suffer for owning underperforming shares, they had a strong incentive to dissolve their cross shareholdings. Thus they have been dumping their previously stable stock holdings in fire sale operations that peaked especially around book closing, such as in March 2001 and September 2001 - each time exerting strong downward pressure on the stock market. Plans were announced to **legally require banks to reduce their stock holdings** further over several years. This completes the unraveling of cross shareholdings that has been taking place throughout the 1990s. By 2005 the cor-

{p. 191} porate governance landscape will be reshaped - the main bank system is becoming history. Cross shareholdings will have become the exception, not the rule. As a result, accountability to shareholders is beginning to become a reality for the first time since the 1920s. Corporate management is becoming increasingly profit-oriented, and companies are run for the benefit of shareholders, not managers and employees. Capitalism for capitalists has returned to Japan.

Change Is on My Mind

Before countries change, mind-sets must change. There can be no doubt that the new consensus against the postwar system emerged as a result of the recession. There may be a way to quantify this. Considering the four Nikkei newspapers in Japan and counting the number of articles in a year that were devoted to three key topics of structural change, we find evidence of such change.11 Figure 15.3 shows that articles on *amakudari* **(bureaucrats parachuting into private-sector positions and hence informally controlling the industries they have previously supervised**) began to soar from 1992 onward. The **foreign-domestic price differential** (Figure 15.4), a reflection of Japan's closed, export-oriented economic structure, became a buzzword from 1992. Discussions of deregulation (Figure 15.5), with several thousand articles written in a year, really took off in 1992. One may wonder what happened in that year. The simple answer is that 1992 was the year when the recession started. As a result, the old economic structure was criticized and a fundamental rethinking began.12

The postbubble recession of the 1990s succeeded in shifting the consensus from being in favor of the wartime economic system, as was still the case in the mid1-980s, to its diametric opposite. Today, most intellectuals in Japan have come to agree with the slogan of Prime Minister Koizumi, who started his reform-oriented administration in 2001: no economic recovery without structural change. It has become a consensus in Japan that the old system does not work anymore and has to be scrapped.

Observers even began to wake up to the wartime roots of the postwar system - and that seemed to further condemn it. An editorial in the widely read Yomiuri newspaper suddenly thundered in mid-2000, "In the ten years since the collapse of the bubble economy, the government has tried every financial and fiscal policy possible. But the economic slump is still continuing because the government has never attempted to revamp the fatigued economic and social systems of the wartime regime."13 The ten-year slump seemed evidence enough to most observers that the postwar system did not work anymore.

There can be little doubt that later historians will conclude that the slump of the 1990s marks a historic turning point in Japan's economic, social, and political system. Believing that the system itself was to blame, **policymakers scrapped the structure that had created the postwar miracle economy. They abandoned the war economy system**. Japan is now well advanced on the path to implementing U.S.-style capitalism. It appears as if the Bank of Japan has done the right thing, after all.

{p. 192} Figure 15.3 Articles with Keyword "Amakudari" in the Nikkei Newspapers

Figure 15.4 Articles with Keyword "Foreign-Domestic Price Differential" in the Nikkei Newspapers

{p. 193} Figure 15.5 Articles with Keyword "Deregulation" in the Nikkei Newspapers

Shareholder Capitalism or Welfare Capitalism?

Even if we ignore the inappropriate way in which the central bank facilitated these structural changes, there are two reasons why its actions were not justified. First, **there was an alternative for Japan to introducing U.S.-style capitalism**. The problem of falling factor inputs and low productivity that Japan experienced beginning in the 1970s did not mean that the old system had to be abandoned. It could simply have been adjusted. **All that was needed was to use the key control tool, credit creation, to supply the nonmanufacturing and service sectors**, especially high-value-added activities such as education, research and development, information services, software development, and telecommunications, as well as welfare-enhancing projects such as housing and public facilities and environmental projects and industries, **with new purchasing power**. **Incentive structures could have been redesigned to allow for a greater degree of individual freedom and public debate**. Purchasing power allocated to low-productivity activities, such as the traditional distribution system, sunset manufacturing industries, and the like could be slowly phased out, thus producing a natural shrinkage of these sectors and efforts to restructure or relocate offshore.

With such credit policies, the emphasis of Japan's economic system would quickly change. **The structure of the miracle economy, based on capitalism without capitalists and competition for size, not profits, could be maintained**. As long as the key control tool, credit creation, was under democratic supervision, Japan's economy could then continue to deliver high economic growth while at the same

{p. 194} time enhancing the standard of living and quality of life of its population, **continuing an egalitarian ownership** and safeguard its achievements in terms of social justice. **The war economy system has helped Japan avoid the disadvantages and significant human costs of free-market-style capitalism**, namely, great **income and wealth inequalities, high unemployment, high crime rates, and social injustice** of many kinds. These advantages could be maintained if the system as such was kept but updated to suit the times.

Such a transformation of a war economy system into a successfully modified and modernized structure has a **historical precedent.** In the early postwar decades, **Germany** underwent a similar structural break when, under Ludwig Erhard, it **made the conscious decision to preserve the advantages of the economic system established in the 1930s but** improve it by shifting its goal further away from output maximization to **raising the standard of living** of the population.

German Model

The result was a combination of the collectivist war economy and the U.S.-style free markets. **Worker protection and participation in corporate management** remained high, ensuring that the **profits produced were divided fairly between** the three stakeholder groups, **shareholders, managers and employees**. The **financial system remained centered on banks**, thus allowing allocation of newly created credit directly to productive corporations. **Speculative loans to the real estate sector were kept low** by regulatory control that implied low loan valuation ratios of real estate-related lending. At the same time, entrepreneurs were rewarded far more than the war economy system allowed. Thanks to the corporatist structure, worker representation ensured that a reasonable share of corporate profits would go to workers and employees, not just fat-cat capitalists. As a result, the income structure remained **far more egalitarian than in the United States**. Most of all, resources were allocated toward raising living conditions.

The Germans called this hybrid economic system the *soziale Marktwirtschaft*, or **social market economy**.14 The postwar transformation succeeded beyond expectations, as the high growth rates of **postwar Germany, also dubbed a "miracle economy,"** attest. Taking purchasing power, size of houses, distance to work, working hours, cost and quality of education, and other such issues into account, there can be little doubt that **the quality of life and standard of living of the average German** is among the highest of the industrialized countries, **exceeding that of the average American**.

Japan could have opted for going the German way in the 1990s. But there was another way to enhance productivity: entirely abandon the war economic system. By freeing the domestic economy from regulations and cartels, by abandoning the seniority pay system, and most of all by making the shareholder the ultimate lord over the firm again, entrepreneurs could be given incentives to start up new, creative firms in the new service industries. Productivity could be

{p. 195} boosted by reversing the half century of war economy and reverting to the freefor-all style of capitalism that existed in the 1920s. But in that case, all advantages of the egalitarian "Third Way" system would be lost, and Japan would also import the disadvantages of unmitigated capitalism that its leaders sought to avoid in the 1930s.

No Public Debate: The Princes Decide for You

Given the significance of the decision whether to reform and improve the war economy system or abandon it entirely and introduce free markets, a widespread public debate would have been crucial. Of course, the cost of changing over from one system to another would have to be added into the calculation, tilting it in favor of going the German way. Ideally, the population would be asked and a decision would be reached in a democratic fashion, based on fair and objective information. In reality, there was no public debate. Very few people were even aware of the issues that were at stake.

The early postwar leaders knew that they were running a war economy, but they chose not to talk for political reasons. **The Cold War propaganda message was that postwar Japan had adopted a U.S.-style political and economic system.** Unwilling to tell the truth, the leaders, including the Showa emperor himself, took their intimate knowledge about the origin of Japan's miracle economy with them to the grave. A generation of bureaucrats and politicians reigned in the 1980s and 1990s who did not even understand the true character and purpose of their own country's economy. Likewise, leading thinkers in the United States have little knowledge about the character of Japan's war economy, its advantages and possibilities. Ironically, **a whole generation of Japan's elite had been sent to the United States to receive Ph.D.'s and MBAs in U.S.-style economics** in the postwar era. They arrived back in Japan trained in the theories of the free markets. **Yet they had never received any formal training in the principles of their own economy**. In the postwar years - partly due to the need to cover up its roots - there had not been a proper theory of how the Japanese war economy system worked and what its advantages were.

Since neoclassical economics assumes that there is only one type of economic system, namely, unmitigated free markets, where shareholders and central bankers rule supreme, **the young, bright Japanese elite quickly came to regurgitate the arguments of U.S. economists**. When U.S. commentators were demanding that Japan change its system, **neither economists and business leaders nor bureaucrats and politicians in Japan were able to counter U.S. arguments**. Many older Japanese leaders instinctively felt that the Japanese system had served the people well and so should not be hastily abandoned. However, they failed to provide a conincing rationale for their arguments. **U.S. leaders, drawing on decades of research into the free market theory, had an easy time winning the public debate**. Thus there has never been a debate about whether Japan's productivity should be enhanced

{p. 196} by reforming the old system or by abandoning it. Those in charge of window guidance never gave such a debate a chance.

Reform Costs Excessive

When considering the option of modifying the Japanese system and entirely scrapping it by means of a long and deep recession, any cost-benefit analysis would have to conclude that it does not make sense to purposely prolong a recession, even if structural benefits emerge in the long run. To use a simple analogy: Cyclical policies aim at economic growth, hence at boosting the size of the national income pie. Structural policies aim at efficiency, which is the ease with which a given pie is cut up and allocated. While structural reform may indeed succeed in marginally increasing the efficiency of the economy, as measured by certain indicators, it seems clear that the enormous economic and social costs of the ten-year recession have greatly outstripped the potential benefits. To prolong the recession for the sake of implementing structural change is akin to **shrinking a cake to a tiny size in order to be able to cut it up more easily.**

Forward to the Past

Many observers are still convinced that the reform plans of Junichiro **Koizumi**, who became prime minister in April 2001, would be positive for Japan. Among them he gave prominence to his **demands that various publicly owned companies, most notably the post office, ought to be privatized**. This is indeed the most concrete reform plan, and one that Koizumi has proposed throughout his career. Yet it is difficult to see how such a reform will affect economic growth. Ownership of the public entities has not changed in the postwar era or even over the past century.

Yet economic growth has changed. Japan moved into recession in the 1990s, although there was no increase in ownership of public corporations. Over the long run, if anything, one may detect a positive correlation between growth and the existence of these public institutions - their creation provided some of the infrastructure for Japan's phenomenal economic growth.

What, then, is the attraction of privatization? It is often argued that privatization increases efficiency, as market forces will make those firms more productive and profit-oriented. Yet Japan's public-sector employment as a share of total employment remains modest by international comparison. Moreover, the quality and reliability of public services must rank among the top in the world.

It is true that selling the public utilities to private investors is likely to boost the profit orientation of these entities. But is this necessarily a good thing'? **Private sector firms look after the interests of their owners. To avoid this is precisely why public-sector institutions were created**: They are supposed to work in the interest of the public. It is well known that markets cannot effectively manage goods from

{p. 197} which everyone can easily benefit, namely, such public goods as the environment. education, and public infrastructure (such as parks, roads, and postal services). Private owners would not invest as much as is socially efficient. This market failure is why public goods usually are kept in the hands of the government. This is also true for industries with a natural monopoly that can only sustain a small number of firms. Leaving their operation in the hands of the private sector would lead to monopolies that disadvantage consumers by pushing up prices and reducing the amount and quality of services.

Japan introduced a publicly owned postal service because it is beneficial for society if the post office services all regions, even remote ones, at the same price. To boost profits, a privatized postal service will no doubt close a large number of offices. Prices of all postal services are likely to rise, while many unprofitable but convenient services are likely to be canceled. Transaction costs for the general public will increase. What is efficient for the new private owners will in part be inefficient for the public. As a result, privatization will most likely shift money from the pockets of ordinary citizens into those of the new shareholders.

The same applies to education, which is the foundation of economic development in any country. To boost Japan's long-term growth rate and benefit the majority of the public, **Japan created public schools and universities, which have very low fees.** The highest overall level of education can be achieved in an open, merit-based educational system that offers **equal opportunities for everyone, no matter how wealthy one's parents are**. This has been one of the pillars of the successful ealitarian, classless societies that boast high standards of living, such as Sweden, Germany, Japan, and other Asian countries.

Koizumi is now proposing to move Japan more in the direction of Britain, where the educational system has not adequately dealt with the bias against the less well off and where the privatization of public corporations has not visibly worked in the interest of consumers and the general public.15

A lingering worry is that public institutions do not motivate their staff properly, which privatization could change. Indeed, if there is underperformance, something should be done about it. But **the performance of staff can be increased by implementing the right incentive structures without changing ownership**. Apart from the ownership, the differences between public and private bureaucracies are in any case small: large firms are in their structure similar to civil service bureaucracies.

The End Does Not Justify the Means

We have examined the case that, perhaps, the Bank of Japan's means to achieve its end could be justified by the positive nature of that end. However, this argument does not hold. There is therefore no good economic rationale for pursuing the types of policies that the Bank of Japan has pursued over the past decades. This

{p. 198} leaves us with the fact that the decision on structural reform is ultimately a political one. Irrespective of the ultimate goal, the question here is whether the implementation of a long-term structural change agenda that affects income and wealth distribution, social and economic institutions, and society in general is really the task of unelected central bankers. Nothing in the Bank of Japan Law, old or new has ever awarded the central bank such a mandate. In Posen's words: "No Japanese citizen elected the BoJ to pursue this policy of promoting restructuring, and in fact no elected official delegated this task to the BoJ or put the goal of 'encouraging creative destruction' into its mandate."16 To create public consensus on the "need" for structural reform by purposely creating a recession must constitute an abuse of power.17 ...

{p. 208} 17 The Asian Crisis and the Central Bankers

The Asian Crisis

Japan was not the only high-performance economy in Asia that in the 1990s found itself in the deepest recession since the Great Depression. **In 1997, the currencies of the key Southeast Asian countries** could not maintain their fixed exchange rates with the U.S. dollar. They **collapsed by between 60 and 80 percent within the year**. This boosted the value of their large foreign liabilities. Unable to pay their debt and facing the possibility of national default, Thailand, Korea, and Indonesia asked the IMF for emergency funding. **The IMF stepped in, but only in exchange for a set of stringent policies. Instead of improving, the economies of Thailand, Korea and Indonesia deteriorated throughout 1998**. The banking sectors verged on totai default. Economic growth contracted. In Thailand, the country where the crisis started, manufacturing production fell by the largest amount in more than forty years. Stock markets collapsed.

Crisis Due to Economic Structure?

What had happened? **Alan Greenspan, the chairman of the U.S. central bank, as well as Robert Rubin, then U.S. Treasury secretary**, led a chorus of commentators who asserted that **the Asian crisis was the result of the Asian economic system**, which was based on closed markets and government interference.1 Although commentators from Europe and the United

States had in preceding years praised the virtues of Asian-style capitalism, they were now virtually unanimous in their belief that the Asian crisis was **due to the informal links between governments and big business (now called "cronyism")**, the large reliance on **bank lending instead of stock market finance** (now referred to as "bloated banking systems" and "debt mountains"), and the many forms of government intervention in the markets (now called "government meddling").

It was not surprising that observers trained in the tenets of a particular branch of neoclassical economics should come to this conclusion. As we have seen, this

{p. 209} approach to economics **axiomatically assumes that only free market economies can be successful**. Asia, just like Japan and Germany, had achieved high growth under conditions where the influence of individual shareholders was restrlcted, managers were given a freer hand, **credit allocation policies guided the financial sector and government intervention was pervasive. As in Japan, the roots of the Asian system could be found in** the dark days of **the Second World War, when governments reorganized their economies for maximum resource mobilization following the German blueprint**. Highly successful, the Asian miracle had been the biggest thorn in the flesh for mainstream economists. No wonder, then, that proponents of mainstream economics were relieved to find that such a system was, finally, underperforming. Since **the IMF also subscribes to the neoclassical approach, its officials were quick to claim that the crisis was the result of the Asian system**. Based on this assertion, the IMF then made any provision of loans to Thailand, Indonesia, and Korea conditional upon a historic transformation of their economic structures.

But the crisis years, even though they were prolonged over a decade in Japan, were still the exception. There can be no doubt that the Japanese-style mobilized economy not only worked extremely well for Japan, but in various modified forms also contributed to the "miracle economies" all over Asia. **Until 1997, the macroeconomic performance of Thailand, Korea, Indonesia, Malaysia, Singapore, and Taiwan was widely praised** by commentators, academics, and policymakers alike. Economic growth of the first three countries averaged in the double digits for most of the 1970s, the 1980s, and the first half of the 1990s. Per capita income grew 5.5 percent on average from 1960 to 1990.3

While there were periods when other developing countries also grew fast, no others have managed to sustain such high growth rates as these for three decades. But the achievements of these economies did not end with such impressive growth rates. They also attained **remarkably low levels of income inequality** and have been unusually successful in **reducing poverty**. Moreover, **life expectancy improved** by more than in any other region.4

It is therefore relevant to find out whether the Asian crisis really was the result of the Asian system. A thorough study of its causes reveals that, quite **to the contrary, it was the policies "recommended" by the U.S. Treasury, the IMF, and the local Asian central banks that resulted in the Asian crisis**.5 While the Asian central banks previously had had no independence and few legal powers, **after the Asian crisis almost all of them had become independent and unaccountable** for their actions.

Cause of the Asian Crisis

In Thailand, the country where the Asian crisis erupted first, the causes go as far back as **1993. In that year, Thailand implemented a policy of aggresslve deregulation of the capital account and the establishment of the Bangkok Internatlonal**

{p. 210} **Banking Facility (BIBF). This banking facility enabled the corporate and banking sector to borrow liberally from abroad** - the first time in the postwar era that Thai borrowers could do so. In the words of an expert observer: "This plan [implementation of the BIBF] was **initiated in 1990 by the Bank of Thailand** [Thailand's central bank], which, in view of the successful financial liberalization carried out so far, felt that Thailand was ready and the timing and opportunity were right."**6 Korea and Indonesia adopted similar policies around the same time** again, postwar firsts.

There is no doubt that, as with Japan's liberalization of capital flows in December 1980, this marked a major departure from the old economic structure. What is less clear is just **why such liberalization of capital flows was adopted. There was no need for Thailand to borrow money from abroad**: It boasted a high savings rate had sufficient foreign exchange reserves, and possessed a large and vibrant banking sector and a central bank. **All the money necessary for domestic investments could be created at home.**

Indeed, **the pressure to liberalize capital flows came from outside Thailand.** Since the early 1990s, **the IMF, GATT (predecessor of the WTO), and U.S. Treasury had been lobbying Thailand, as well as other Southeast Asian nations, to allow domestic firms to borrow from abroad**. Such liberalization of capital flows had been **the key U.S. demand in almost all APEC summits since 1993**.7 The U.S. argument in favor of liberalization was that borrowing from abroad would enable Thailand, Korea, Indonesia, and their neighbors to run balance-of-payments deficits, which could be funded by capital inflows. Moreover, the IMF and the U.S. Treasury argued that neoclassical economics had proven that free capital markets and free capital movement increased economic growth.

These arguments, emerging from Washington, were not convincing to some developing countries that had for decades studied the options available to them. **India, most notably, had consistently refused to deregulate the capital account and again in the 1990s resisted U.S. pressures**.8 The Indians had good reasons: The experience of the 1970s and 1980s in almost all **Latin American countries had proved that the liberalization of capital flows might result in an excessive buildup of foreign debt**. That was not only expensive, as the foreign debt had to be serviced and hence **valuable domestic resources would constantly flow out of the country as interest payments**, but also dangerous. The Old Testament advises that **the borrower is servant to the lender**. By becoming indebted, developmg countries became more dependent on the lender countries. And the **lenders could quickly withdraw their funds at any time** if they so wished. If the loans could not be paid, **the collateral could be called in, such as equity in indigenous industrie**s. This was the experience of many Latin American countries that implemented the liberalization and deregulation policies that the IMF and the U.S. Treasury had recommended to them before their crises of the 1970s and 1980s.9

Most of all, it did not make much economic sense for a country to borrow

{p. 211} significant amounts from abroad in order to fund investments at home. History shows that **successful economic powers, such as Germany or Japan, developed their economies with little foreign borrowing**. As long as a country has an indigenous banking system, it can create all the necessary money through its banks or central bank, without the need to become dependent on the whims of foreign interests.

Central Bank Policies

There was also a domestic force in favor of capital account liberalization: the central banks of Thailand, Korea, and Indonesia, and the economists of their research departments. They argued that such liberalization would improve resource allocation. This line of argument was picked up by neoclassical economists at home and abroad, who already knew this to be true. While India resisted the pressures from the U.S. Treasury and Wall Street, on one hand, and central banks and neoclassical economists, on the other, the leaders of Thailand, Korea, and Indonesia eventually gave in. **By 1993, they had all deregulated their international capital flows.**

By doing so, they had committed the first of a series of crucial policy mistakes that would throw their countries into the biggest disaster in the postwar era. The next policy step toward financial meltdown was again taken by **the central banks. They set about creating irresistible incentives for domestic firms to borrow from abroad.** The impact of the BIBF was foreseeable, with one expert writing as early as 1995, "Large corporations will seek to obtain more funds through the BIBF," hence from abroad.10

The central banks in Thailand, Korea, and Indonesia emphasized in all their public statements that they would, at all costs, **maintain fixed exchange rates** with the U.S. dollar. On the other hand, **they raised domestic interest rates above U.S. dollar interest rates**. Since **the capital account had been deregulated, this meant that rational domestic investors were now given maximum incentive to borrow from abroad**. Who would want to take out more expensive domestic loans if foreign loans were cheaper and the central bank guaranteed that there was no exchange rate risk? Hence **billions of dollars were borrowed on a short-term basis from abroad by these countries in the years between 1993 and 1997**. Net private capital inflows into Asia surged from U.S. $54.3 billion in 1993 (sharply up from U.S. $20.9 billion in 1992) to U.S. $98.3 billion in 1996.11

The pattern of consistent policy "mistakes" by the central banks continued. **For decades, the central banks of Thailand, Korea, and Indonesia had been using their own version of window guidance credit controls (in Korea, they were known by the same name; in Thailand they were called the "credit planning scheme")**. From 1993 onward, these central banks then implemented policies not dissimilar to those of the Bank of Japan in the 1980s - they raised the loan growth quotas that they were allocating to the commercial banks. **Banks were ordered to increase lending. They were faced with less loan demand from the productive sectors** of the economy, {p. 212} **because these firms had been given incentives to borrow from abroad** instead. But the banks had to meet their increased lending quotas. They therefore had to resort to increasing their lending for speculative purposes. Lending to the real estate sector and nonbank financial institutions soared. The rest is history. This **excess credit creation did not** primarily **lead to** more **consumer price inflation**. Since **the money was used** for transactions **to purchase assets, it had to result in asset inflation. Land and stock prices soared.**

Policy Mix to Create a Crisis

If the aim of the central banks had been to create a financial crisis, complete with currency collapse and economic recession, the combination of their policies could not have been more suitable. The economic outcome was predictable, inevitable and should not have surprised anyone, least of all the central banks. **Since the domestic economy boomed due to the credit bubble, imports were bloated**. Moreover, the **fixed exchange rate with the U.S. dollar was maintained at greatly overvalued levels, especially since the 80 percent weakening of the yen between 1995 and 1997**. As a result, the **exports of the Asian countries dropped sharply**. With exports falling and imports rising, the trade balance plunged into a large deficit. But thanks to the substantial foreign borrowing of the corporate sector, **capital inflows were so large that they plugged the hole in the trade balance**. This ensured that the otherwise unsustainable economic boom and trade deficit could continue for several years.

The danger was that the capital inflows were of a short-term nature and could be withdrawn at short notice. What happened next was the inevitable result of the explosive policy mix adopted by the East Asian central banks. **Foreign investors began to worry that this unsustainable situation was about to give way to a crisis**. The question had become not whether the Asian currencies would collapse, but when. Investors who could forecast the timing of the collapse of the dollar pegs would make fortunes. **The hedge funds, quite familiar with the games played by central banks and the IMF from decades of experience in Latin America**, **watched the ratio of foreign exchange reserves to short-term foreign-currency-denominated loans**. Once the loans from overseas had reached a multiple of the foreign exchange reserves, **one had to bet on a devaluation of the respective currency**. To defend their currency pegs, the central banks had to use up precious foreign exchange reserves. As other investors became worried and pulled out their shortterm foreign lending, more foreign exchange reserves would leave the country. Eventually, the outflow would turn into a flight of capital. **The stampede for the door by foreign lenders would quickly exhaust all foreign exchange reserves**, if central banks continued to insist on maintaing the dollar pegs. And **once the foreign reserves had disappeared, the currencies would have to be devalued anyway**. That was the bet of the **speculators**, who **could then make hundreds of millions of dollars in profits**.

{p. 213} More Central Bank Mistakes

When speculators began to sell the Thai baht, the Korean won, and the Indonesian rupiah, **the respective central bank in each country failed to implement the right policy response**. That would have been to immediately **abandon the overvalued exchange rate and devalue**. Any attempt to defend the peg would merely waste valuable foreign exchange reserves and thus make matters worse. The central banks knew that if the countries ran out of foreign exchange reserves,

they would have to call in the IMF to avoid default. And once the IMF came in, **the central banks knew what this Washington-based institution would demand** - for its demands in such cases have been the same for the previous three decades.12 **In each case, one of the biggest winners in the domestic economy would be the central bank, which would be made independent**. Instead of devaluing, the Bank of Thailand, the Bank of Korea, and the Bank of Indonesia responded with futile attempts to maintain the peg until they had squandered virtually all of their foreign exchange reserves. Especially in the case of Thailand and Korea, these had been substantial when the crisis broke. But with all the foreign exchange reserves lost, these countries did not have enough short-term funds to cover their balance-of-payments deficit. Moreover, **the delay of the devaluation gave the foreign lenders ample opportunity to withdraw their money at the overvalued exchange rate**. Faced with default, the central banks of the three crisis-stricken countries advised their governments to ask the IMF for help.

The Quiek Solution to the Crisis

What type of policies should the IMF have advocated in order to end the crises quickly and maintain stable growth? The most important domestic aspect of the crisis was identical to the Japanese recession. In their attempts **to defend their currencies, central banks raised their interest rates** sharply. **This pricked the credit bubbles**, and it was clear that a credit crunch would follow if the right policies were not taken. So the policy prescription that **the IMF should have recommended** was a **reduction in interest rates and**, more importantly, an **expansion of credit creation** by the central bank and the banks. In order to stabilize the foreign exchange rate, **controls on short-term capital movements should have been reintroduced**. Finally, **the central bank could have purchased all bad debts at face value**. With these simple policies implemented swiftly, the crisis could have been ended within about six months and a credit crunch recession avoided. Indeed, **it is similar such policies that Malaysia - which refused to hand over control to the IMF - pursued**.

Thailand's leaders initially also had comparable ideas, it seems. Soon after the baht crisis broke in Bangkok in May 1997, the Thai finance minister and the prime rninister felt that they should simply borrow some more money to bridge the temporary balance-of-payments crisis and implement a bailout program. Who would

{p. 214} lend to them without too much ado? **The biggest foreign investor in Thailand was Japan. And Japanese companies, Japanese banks, and even the Japanese government had a vital interest in quickly ending the crisis and preventing it from widening**. Hence on July 16, the Thai finance minister, Thanong Bidaya, took a plane to Tokyo. He met the most senior government and Finance Ministry figures and held urgent discussions. All Thailand needed was around U.S. $20 billion. Japan at the time had U.S. $213 billion in foreign exchange reserves - more than the total resources of the IMF. 13 Clearly, Asia did not need the IMF. Japan could just as easily have done the job. And Japan was willing. Politically, Japan had found it hard to play a more active role in Asia in the postwar era, and now that its Asian neighbors were in deep trouble Japan had a chance to prove that it was a reliable neighbor willing to help out.

Washington Stopped Japan

In response to Thailand's request, **the Japanese government began to talk of an Asian crisis fund. The vice minister of finance at the time, Eisuke Sakakibara went as far as proposing** that **an Asian Monetary Fund** should be established, so that there would be no need to get the IMF involved. **In theory, Washington should have been delighted, as for years it had criticized Japan heavily for not playing a political role commensurate with its large economic weight**. Now Japan was even offering to bail out Asia single-handedly, thus saving the IMF and its main contributor and shareholder, the United States, a lot of money. Moreover, there could have been little doubt that Tokyo would have adopted appropriate policies to quickly end the emerging crisis. Japan has long experience with capital controls and has used them successfully and fruitfully when they were necessary. **Japan would have allowed the Asian economies to reflate and bail out their banking systems without closing them down**. That would have prevented a full-blown credit crunch and likely avoided any recession.

But **Washington** stopped Japan's initiative. It unambiguously **let Tokyo know that it was not allowed to rescue its Asian neighbor**s. Any solution to the emerging Asian crisis had to come from Washington via the IMF. Japan thought it could convince Washington otherwise, but failed. It was forced to withdraw its proposals. The same fate awaited **Taiwan**, which **was also not permitted by the United States to help out its Asian neighbors** through loans.

The Screws Tighten

As a result, the leaders of Thailand (and later Korea and Indonesia) felt that they had no choice but to follow the advice of their central banks and invite the IMF. The "help" of the IMF was indeed swift. But it took quite a different torm from what was necessary for a recovery, and also from what a Tokyo initiative would have offered. In exchange for supplying enough short-term funds to avoid insol-

{p. 215} vency. **the IMF demanded a string of policies, including sharp rises in interest rates, curbs on** central bank and bank **credit creation, and deep structural reforms encompassing major legal changes**. These policies were "performance criteria" that were nonnegotiable.14

The structural reforms increased deflationary pressure. The **forced reduction in credit creation** reduced demand further. The excess credit creation of the previous years thus turned into nonperforming loans. Burdened with large amounts of bad debts, the banking systems of Thailand, Korea, and Indonesia were virtually bankrupt. As credit creation fell, domestic demand shrank. Even otherwise healthy firms started to suffer from the widening credit crunch. As this forced firms to reduce capital expenditures, lay off staff, or close down altogether, unemployment rose, disposable incomes shrank, and the propensity to consume fell. The slump in domestic demand hurt the corporate sector further and raised the number of bankruptcies and loan defaults. As bad debts rose, the banks would lend even less. In this situation, attempts to stimulate the economy via interest rate reductions had to fail. **Despite a declining price of borrowing, the quantity of credit creation dropped. Industrial production and output collapsed**. Corporate bankruptcies soared. Unemployment rose to the highest levels recorded in the Asian countries since the 1930s.

What Were the Aims of the IMF?

The story seems familiar. Since **the IMF's own internal macroeconomic model uses credit creation as the key variable, there can be no doubt that the IMF knew well what the consequences of its policies would be**.15 In the Korean case, **the IMF even had detailed but undisclosed studies prepared that had calculated just how many Korean companies would go bankrupt** if interest rates were to rise by five percentage points. The number was substantial. Yet the IMF's first agreement with Korea demanded a rise of exactly five percentage points in interest rates.16

It almost seemed that the main interest of the IMF was not in the creation of quick recoveries. The two key demands that the IMF was adamant to push through involved legal revisions that were to **change the nature of the Asian democracies**. Arguing that the crisis had been due to the economic structure, not the wrong combination of monetary policies, the IMF demanded that in Thailand, Korea, and Indonesia **the laws should be changed so that foreign investors would be allowed to purchase land and to take over banks and key industries.** The governments had to obligate themselves not to rescue bust banks but to close them down and sell them off cheaply as distressed assets, **often to large U.S. investment banks**. In most cases, the **IMF-dictated letters of intent explicitly stated that the banks had to be sold to foreign investors**, although, economically speaking, there is no rationale why this should be necessary.

The other key demand in the IMF list of conditions was that **legal changes were required to make the central banks independent - and de facto unaccountable**. Yet there was one place the central banks were closely coordinating their policies with:

{p. 216} the IMF itself. Immediately after arrival in the crisis-stricken countries, the **IMF teams set up offices inside the central banks of Thailand, Korea, and Indonesia** from where they dictated what amounted to terms of surrender, practically ruling the economy as an unelected government.

Instead of analyzing the real causes of the Asian crisis and learning the lessons - namely, to make central banks more accountable and less independent in their key policy tool, the quantity of credit creation - the IMF ensured that the central banks would be rewarded for their actions.

Studying the personnel policies, it can be found that, exactly as in the case of Japan, **key individuals at the central banks who** had decided to **increase bank credit creation before the crisis, and** who had **favored the liberalization of capital accounts**, the maintenance of the dollar peg, and higher domestic interest rates, **were promoted after the crisis and continued to control the central banks**.17 Today, the central banks of Thailand, Korea, and Indonesia are all legally independent. They have not been held accountable in a meaningful sense for their disastrous policies.

Further research is clearly needed on the true motivations of IMF policies and whether there is any causation in the correlation observed by **former World Bank chief economist Joseph E. Stiglitz** between the policies advanced by the IMF's deputy managing director during the Asian crisis and his subsequent employment at the largest U.S. bank. Stiglitz concluded: **"Looking at**

the IMF *as if* it were pursuing the interest of the [U.S.] financial community provides a way of **making sense of** what might **otherwise** seem to be **contradictory and intellectually incoherent behaviors**."18

It is noteworthy that international organizations appear aware of just what provides the main opportunity for increasing foreign ownership in other countries and implementing deep changes in their economic structure. For instance, **World Bank staff argue that a "crisis can be a window for structural reform," and it can "be an opportunity to reform the ownership structure in the country**."19 The view that a crisis is "an opportunity" or a "window" suggests that it is, in some respects, to be welcomed.

Calling Of the Crisis

The policies of the Asian central banks closely resembled those taken by Hjalmar Schacht in the 1920s, which made the German banking system dependent on short-term capital inflows from the United States - whose sudden withdrawal was then allowed to bankrupt the banking system and much of the corporate sector, creating mass unemployment. Until early 1998, therefore, it seemed that things went well for the structural reformers. Asia was getting ever more deeply engulfed in the crisis. Then, however, two events occurred that changed the picture. As a result, the recession policies were abandoned, and an expansionary monetary policy was adopted, sanctioned by the IMF.

The first event was the **increasing awareness among Asian leaders of what game was being played, and hence an increasingly hostile attitude toward the IMF and**

{p. 217} **the U.S. Treasury**. The Malaysian leader, Mohammad **Mahathir, early on blamed international capital and foreign interests for the creation of the Asian crisis**. He became increasingly critical of the IMF and the policies in Asia, which his government had initially also begun to introduce in Malaysia. But in September 1998, **Mahathir imposed controls on short-term capital movements** and hence stabilized the exchange rate. Simultaneously, **his central bank stepped up credit creation and the government implemented a program to clean up the balance sheets of banks**. None of the IMF-style structural or legal changes were implemented. This posed a problem for the IMF: The way the **Malaysian** economy was managed, there **was going to be a significant recovery, while the IMF client countries Thailand, Korea, and Indonesia** would continue to be mired in deep and steadily **worsening recessions**. If that happened, **it would become obvious to onlookers that IMF policies were the cause of the Asian recessions** and that sensibly administered capital controls would enhance social welfare.

Mahathir's policies could not fail to boost the economy. The exchange rate stabilized, foreign exchange reserves shot up by 33 percent in the first half year after the introduction of capital controls, and exports grew by double digits in early 1998, exceeding those of Malaysia's Asian neighbors. Most of all, **since there was no IMF demanding the closure of banks and the sell-off of their assets, far fewer companies went bankrupt and unemployment stayed at lower levels**.20 As a result of the better economic performance, ironically, foreign investment had actually increased.

Since continued attacks in the world media on his policy decision to curtail capital flows failed to dissuade Mahathir, **the IMF had no choice but also to give the signal to end the Asian crisis in Thailand, Korea, and Indonesia.** Suddenly, the IMF allowed the central banks in those countries to create credit rapidly. As a result, economies bottomed in late 1998 and began to recover in 1999. Since Korea had most faithfuly implemented all IMF demands, **it would look best for the IMF if the Korean recovery was** also **the strongest**. Credit creation by the Bank of Korea in mid-1998 shot up by the biggest amount in twenty-five years - quite parallel to the BoJ's reflation. As a result, Korean economic growth expanded sharply in the first quarter of 1999. Industrial production rose by double digits in mid-l999, and GDP growth followed. This policy U-turn was probably possible from the IMF's viewpoint because some changes had already been achieved: **the crisis had changed governments in all countries concerned; legal changes had allowed foreign interests to take over many key banks, corporations, and real estate**; and the central banks had all received full legal independence.

Cronyism in Wall Street

Later in 1998, another problem developed that further accelerated the reflation policies now pursued by the IMF in Asia: What started as a regional Asian crisis quickly began to engulf the entire world. Investors who had lost money started to pull their investments not just out of Asia, but also out of other emerging markets.

{p. 218} On August 17, 1998, **Russia defaulted on domestic debt. Next, Brazil teetered on the verge of collapse. By September 1998, several major hedge funds had lost billions of dollars**; most notable among them the Connecticut-based long-term capital management (LTCM). This hedge fund accepted as clients only high-net-worth individual investors and institutions. It had accumulated an estimated U.S. $5 billion from them. However, the fund used this money as collateral to borrow even more money from banks. The banks thus created new credit and gave the hedge funds such as LTCM new purchasing power over resources. **LTCM leveraged its capital by more than twenty-five times in the year before its collapse**, thus borrowing more than U.S. $100 billion from the worlds' banks. However, similar to the Japanese bubble of the 1980s, this purchasing power was not used to invest in the creation of new goods and services. It was invested purely speculatively. When the Asian crisis had affected world financial markets, **LTCM's losses threatened to undermine the banks that had lent to the fund with the possibility of a systemic banking crisis** that would endanger the U.S. financial system and economy.

The reaction of the U.S. Treasury and the U.S. Federal Reserve was indicative of their true attitude toward Asia, where they had consistently insisted that hundreds of banks had to be closed, employees laid off, and the assets sold off cheaply.2l **In Asia, government-organized bailouts** to keep ailing financial institutions alive **were not allowed**. But when a similar crisis happened back home in New York, the very same institutions reacted differently: At the end of September, William McDonough, the chairman of the New York Fed, summoned some of the most powerful men of world finance to the boardroom on the tenth floor of the New York Federal Reserve. The assemblage included the **chairmen of J. P. Morgan, Travelers, Merrill Lynch, Goldman Sachs, and Morgan Stanley**, together with heads of the top European banks and board members of LTCM. Instead of closing down the hedge fund, **the Fed organized a**

cartel-like bailout for the ailing LTCM by leaning on Wall Street and international banks to contribute funds so that it could roll over its liabilities. A full-blown default was therefore averted. But as a result, the banks' exposure had actually increased.

To the Asians this made it obvious that **two different standards had been applied**. The Asians had been told by Washington that precisely this type of rolling over of liabilities of ailing financial institutions must not happen, that the institutions must be closed down. Moreover, the criticism of Asian countries as being infested with "cronyism" was seen for the bigotry it was, as LTCM was said to have personnel links to the Fed. **The 2001 Enron bankruptcy, followed by other high-profile accounting and fraud scandals, further blurred the distinction between Asian-style and U.S.-style cronyism**.22

Japan and Asia

Feeling betrayed by America, many Asian leaders thought it was time the Asians got closer together. Indeed, Europe had united already. America is forming a free

{p. 219} trade zone reaching from Alaska to Chile. But Asia still may seem to be out in the cold. Until recently it had not been viable as a trade bloc. From Japan to China, Korea to Indonesia, **virtually all Asian economies were heavily dependent for their economic growth on exports**. Unlike the European Union, the majority of Asian exports are not directed to countries within the region. **Asia is heavily dependent on countries outside its regions as export destinations**. This dependence on export markets outside Asia has been an important economic, if not political, reason why the formation of an Asian trade area has been slow to develop. **For Asia to be able to form an autarkic bloc** and hence reduce the potential risk from inward-looking regions in Europe and America, **Asia needed a market able to act as final export destination** for its consumer products. That market must be as highly developed and as large as Europe or America. In the Asian region **there is only one country that could hope to foot this bill - and that is Japan.**

Japan has been intimately involved in the integration and development of Asian economies since the 1930s. However, as other Asian economies have been developing rapidly in the 1980s, the Asian trade area has begun to run into **a problem that prevents it from becoming a trade bloc similar to the European Union. That problem was the closed Japanese market**. An Asian currency bloc will work **only if Japan opens itself more widely to Asian imports - and not only those manufactured by Japanese plants abroad**. Only then would an Asian bloc become less dependent on exports to Europe and America.

The third shift of Japanese factories into Asia, and hence the final phase of the creation of an Asian economic zone, has **started with the Asian currency devaluations and economic downturns that began in 1997**. As Asian currencies fell up to 80 percent against the U.S. dollar, the production bases of Japanese manufacturers in Asia were suddenly far more competitive than could have been hoped. Though factories that produced output for domestic consumption would be affected by the prolonged Asian slump, **more than half of Japanese factories abroad have been serving as offshore production bases from which to reexport** to other parts of the world, including Japan.

Already, more than half of all automobiles made by Japanese companies, half of all machinery, and a quarter of all manufactured output are produced outside Japan.23 This almost means the creation of a second Japan beyond the borders of its archipelago, mainly in Asia.

Japan will directly benefit from the fast-paced development of the Chinese economy, exporting not only manufacturing plants but also technology and knowhow. Moreover, **as China develops, it will offer a prodigious market for anyone ready to capture it - and Japan will be ready** to supply both products and services. Japanese systems have the unique opportunity to evolve into the standard for the entire Asian region. The increasing expansion of Japanese industry abroad will be another factor necessitating fundamental changes in the domestic structure, for as manufacturing jobs are exported to Asia and the rest of the world, **service and nonmanufacturing jobs will have to be found for the workforce at home**.

{p. 220} On the Road to Asian Currency Union

Once central banks had achieved independence from their national governments and parliaments, power to control the entire Asian economic region could now be further consolidated by making formal and public what had been going on behind the scenes: **Central banks had quietly established ties and cooperation, and increasingly talk was heard about the need for currency unification**.

The goalposts had moved closer. The immediate outcome of the Asian crisis in 1997 was that **the Asian countries abandoned their link to the U.S. dollar**. Not only did the dollar link (instead of the overvaluation) receive much of the blame for the crisis, but without any U.S. dollar reserves left, a dollar-based fixed exchange rate was hardly possible. By the time the foreign exchange reserves of most crisis-affected countries had recovered in 1998, the opinion of policymakers had already shifted against a dollar link. **Instead**, the Asian countries were loosely targeting **a trade-weighted basket of international currencies**. Since trade with Japan had become more important by the early 1990s than trade with Europe or the United States, **this naturally gave a big weight to the Japanese yen**. In other words, since 1998, Southeast Asia had de facto already adopted the first stage of **a yen-centered currency system.**

After the dust of the Asian crisis began to settle in 1999, many meetings and conferences of Asian leaders discussed how Asia should organize its financial markets in the future. **Mahathir, keen to counterbalance Washington's influence, had been the first to demand** more formal links between Asian countries - a form of **Asian economic union**. From the Japanese side, the Asian Monetary Fund idea was warmed up again in 1999. The head of the Hong Kong Monetary Authority argued in May 1999 that Asia should move toward currency union. This was endorsed in June 1999 by the president of the Philippines. Meanwhile, think tanks in Tokyo (such as the Asian Development Bank Institute and the Institute for International Monetary Affairs) and **Manila (the Asian Development Bank)** began to draw up plans for a phased introduction of **monetary union, modeled on the process that led to currency union in Europe**: first introducing target zones between exchange rates, then gradually moving on to semifixed and finally fixed exchange rates, so that the public could slowly acclimatize to the ultimate goal.

Since1999, the United States's attitude toward greater Japanese involvement in Asian monetary affairs appears to have changed again, as **talk of an Asian monetary fund is no longer criticized**. Japan has been actively encouraged to increase the use of the yen abroad. This U-turn in U.S. policy may be because Washington and New York never rejected the idea of Asian currency union. **Tokyo was probably only rebuffed with its proposal of an Asian Monetary Fund because it had excluded the United States**.

Future historians may well see in the Asian crisis the trigger for the first step toward the creation of an Asian currency union and the introduction of an independent single Asian central bank. Behind the scenes, the princes from Tokyo had not

{p. 221} been idle bystanders concerning the developments in Asia. **Already in 1991, the eleven central banks of the East Asia and Pacific region formed an exclusive club, called the Executives' Meeting of East Asia-Pacific Central Banks, or EMEAP**. Little known to the public and maintaining a low profile, the central bank deputy governors of the entire region have been meeting twice a year. Since a landmark meeting of all the governors hosted by the Bank of Japan in Tokyo on July 19, 1996, cooperation has been tightened further. It now includes annual governor-level meetings, as well as more frequent meetings of several working groups and study groups per year. **The Bank of Japan has been functioning as the temporary secretariat of the exclusive club. No minutes of the frequent meetings and discussions are published**.

It is surprising that EMEAP could not prevent the Asian crisis despite the fact that the club had forged an agreement concerning cooperation in case of currency crises just a few months before it broke up in 1997. And yet the policies taken by the Asian central banks before, during, and after the crisis were very similar to each other - and indeed similar to the disastrous policies of the Bank of Japan during the 1980s and 1990s.

{p. 222} 18 More Power to the Princes

Crowning the Princes as Uncontested Rulers

On May 21, 1997, the Lower House of the Japanese Diet passed the first revision of the new Bank of Japan Law in half a century. It was passed by the Upper House in June and became effective on April 1, 1998. The old law had given the democratically elected government ways and means to influence the central bank, and it had named "support of national policy" as the main policy objective.

The new law made the Bank of Japan legally independent, with only minimal reporting requirements to the government and the Ministry of Finance. The new law says that "the Bank of Japan's independence in formulating and implementing monetary policy shall be respected." Two paragraphs down it says again: "In implementing this law, the Bank's independence in carrying out its op- erations shall receive sufficient consideration."1 **There are no more government representatives among the members of the new Policy Board. The ultimate threat of dismissal of the governor is gone**. As the official report on the change of the BoJ law recommended, **"The Officers shall not be dismissed for holding opinions different from that of the government."** Article 25 states, "Executives of the BoJ shall not be dismissed against their will during their term of office." Even if Bank of Japan staff are found guilty of misconduct, all the government can do is ask the Bank of Japan itself to "take necessary measures to correct such misconduct." In the new law, "**the power of the minister to conduct on-site inspections shall be abolished**."2 Most of all, "**the broad authority of the minister of finance to issue directions to the Bank of Japan and appoint its Comptroller shall be abolished."**

After half a century of behind-the-scenes battles with the Ministry of Finance and the politicians, the princes had reached their goal: The extensive powers that they had quietly enjoyed throughout the postwar era had now become official and perfectly legal. They had moved up from being backstage manipulators to being the crowned rulers of Japan's economy.

Waking up to Reality

Not long after this momentous law change the politicians woke up to the reality of what they had done. From early 1999 onward, more and more politicians realized

{p. 223} that throughout the 1990s, **the economy could have been stimulated quite easily by an expansion in central bank credit creation.** Throughout 1999, members of the government and the LDP called on the Bank of Japan to increase the credit supply by buying government bonds. Their voices became even louder in early 2001, when the LDP called for "quantitative easing" by the BoJ.

They were too late. Having just been made independent the previous year, the Bank of Japan saw this as the first challenge to its new powers, and vigorously rebuffed the politicians. Governor Hayami and his deputy, Yutaka Yamaguchi, denied that any such "quantitative easing" was possible or would be effective. Throughout 1999, the BoJ failed to increase bond or commercial paper (CP) purchases. Many politicians, not used to a publicly recalcitrant central bank, were infuriated by the cold refusal of the Bank of Japan to budge. But it was too late. The politicians had decided to cut off their right hand by voluntarily giving up control over monetary policy.

The politicians were not the only ones to realize just how powerless they had become. Throughout 1999, and against the expectations of the majority of currency forecasters, the yen strengthened. Worried about the economy and about the employment situation of its citizens, **the Ministry of Finance ordered drastic foreign exchange intervention**. But, as we saw, in a repeat performance of the events of early 1995, **the Bank of Japan sterilized all foreign exchange interventions by selling its bonds to the domestic economy**. Just as in 1995, it oversterilized. Instead of creating credit, the central bank was tightening it at the fastest rate yet seen in the postwar era. This strengthened the yen back to ¥100/$ by the end of 1999.

Those Ministry of Finance officials and politicians who went back to study the new Bank of Japan Law could find nothing to fault the central bank on, for **the only explicit policy goal that the law prescribed was "price stability."** Since **there was no inflation**, the central bank and its decision makers argued, they were fulfilling their duty.

The lobbying by leading Bank of Japan staff of Diet politicians in 1996 and 1997 had paid off. At the time, BoJ insiders such as Yutaka Yamaguchi (later deputy governor) and Toshihiko

Fukui had spearheaded the **campaign that blamed all of Japan's economic ills on the Ministry of Finance**. The grounds for this argument had already been laid by Mieno, who had devoted much of his public life after his 1994 retirement to lobbying in numerous speeches and meetings for a change in the Bank of Japan Law. Given his reputation as the Robin Hood who had pricked the bubble to help poor people, many listened to what this selfless man had to say.

Sovereignty for the Princes

There was another reason why the politicians felt the case for an independent Central bank was sound. To implement changes in Japan, it is always helpful to be

{p. 224} able to refer to the experience of other countries that had already made the change. Then it could be argued that Japan had to follow the international trend. **Japanese politicians had been trained in the postwar era to pay attention to the trends set by the "international community."** So Bank of Japan officials helpfully pointed out that parliaments in many of the advanced industrialized countries had already made their central banks independent.

The most forceful case in favor of central bank independence was made in the Maastricht Treaty of 1992, which laid the foundations for monetary union in Europe. The treaty described the role and function of the **European Central Bank (ECB)**, which started operations as scheduled, on January 1, 1999, and which is **legally the most independent central bank in the world**. According to the treaty, **the ECB was going to be totally independent from and unaccountable to any government and any democratically elected assembly**.

The Maastricht Treaty quickly became the new goal to aspire to among central bankers all over the world. Bank of Japan staff specifically referred to it as the prime example of a "modern" central bank law that enshrined central bank independence from democratic control and only set the task of ensuring price stability.3 Proponents of the Maastricht Treaty based their case on the experience of the German central bank, the Bundesbank. Since that treaty was new, and most central banks in other countries had only recently become independent, proponents of Bank of Japan independence ultimately also referred to the case of Germany, where central bank independence had the longest history. Based on frequent reference to the experience of the Bundesbank, Bank of Japan staff created the impression that the proposed new Bank of Japan Law was within internationally accepted best practice, and Japan merely had to follow the "global standard."

The German Experience

The experience of the Bundesbank remains such a focal point of discussions about central bank independence **that it deserves much closer scrutiny** (which is the purpose of the next chapter). It is well known that **the German central bank,** then called **the Reichsbank, created too much money in 1922 and 1923, and hence caused hyperinflation**. It is normally thought that this is why the postwar German constitution made the Bundesbank largely (though not completely) independent from the government. And indeed, the Bundesbank's track record is very good. It is this experience that probably convinced most parliamentarians in Japan, as well as other countries, that it was the right thing to make the central bank independent.

Yet the German case may not be representative. The chain of logic that led to an independent Bundesbank was as follows: The authors of the German constitution looked back at German monetary policy and determined the biggest policy mistakes. No doubt that was the hyperinflation of the early 1920s. They then set out to ascertain its cause, concluding it was the legal status of the central bank that was the problem. Hence the Bundesbank's status was determined.

[p. 225} Mieno and his fellow officers at the Bank of Japan boiled this down to the formula that the Bundesbank's success was due to its very strong legal independence. They then urged politicians to adopt these conclusions without proper reflection on the true status of the Bundesbank and the chain of thinking that had led the Germans to their conclusions. It was akin to copying steep roofs for houses from Germany and introducing them in Tokyo without realizing that the steep roofs were made for areas with heavy snowfall. If Japan was to truly learn from the German experience, it would, like Germany, have to look back at past monetary policy, determine the biggest policy mistake, find its cause, and then implement a law that prevents any recurrence of that problem. Doing this for Germany, we get quite a different story from the above. As we will see in the next chapter, it turns out that **the monetary policy mistakes of the 1920s and early 1930s were made by a Reichsbank that was totally independent and unaccountable** to the German government or parliament. **This is why**, contrary to popular belief, **the Bundesbank was made less independent and more accountable than the Reichsbank**.

If It Ain't Broke, Don't Fix It: Japan's Inflation Record

Furthermore, by referring to the Gerrnan experience, Bank of Japan staff insinuate that inflation is the biggest problem of monetary policy. While this may have been the case in Germany, in Japan inflation has not been the problem. Compared to virtually any other country, postwar Japan has enjoyed one of the lowest inflation rates. In the twenty years from 1976 to 1996, consumer prices rose by an average of just 2.9 percent per year. In the decade from 1986 to 1996, they rose only 1.2 percent. This is signifcantly lower than the inflation in the United States, which averaged 5.3 percent in the twenty-year period and 3.5 percent in the ten-year period. Many people are surprised to find that Japan's inflation has been lower even than Germany's, the reputed model for low inflation. German inflation averaged 3.1 percent over the twenty years from 1976 to 1996 and 2.4 percent over the decade from 1986 to 1996. The latter figure is exactly twice as high as the Japanese inflation rate over that decade.4 Japan's inflation record is impeccable. It would make the Bundesbank jealous. since nobody criticized the Bundesbank's inflation record or suggested that it needed another legal change to make it even more powerful, why did the Japanese parliament change the Bank of Japan Law?

Japan5 Problem Dramatic Boom-Bust Cycles

While inflation has not been Japan's biggest monetary policy problem, this is not to say that monetary policy has been without serious flaws. We have seen that the biggest problem of Japanese monetary policy has been the creation of boom-and-

{Yes, a dangling sentence. Go and buy the book: new at http://www3.addall.com; second-hand at http://dogbert.abebooks.com/abe/BookSearch?an=richard+werner&tn=princes+yen}

{p. 232} 19 The Revival of the Reichsbank

In many countries today ... monetary policy making is entrusted to an independent central bank. This reflects the human wisdom that has been nurtured by history.

- Yasushi Mieno, governor of the Bank of Japan1

The Fed, the European Central Bank and the Bank of Japan together set monetary policy for a zone that accounts for 80 per cent of the world's industrialized economic activity.... Rarely, if ever, can so much power have been wielded by such a small number of institutions sitting outside the direct democratic process.

- Goldman Sachs economic research2

Greenspan is part of a trend that's been sweeping the globe in recent years: Central bankers are running the world nowadays. An unelected economist, he's been holding America's economic reins. ... In Europe, 12 countries have adopted a single currency and effectively forfeited economic sovereignty to the European Central Bank.

- William Pesek Jr:, columnist, Bloomberg News3

Recession - But Nothing We Can Do

Commentators seem to agree that today central bankers are in charge. In his article entitled **"When Central Bankers Run the World,"** Bloomberg financial columnist Wllliam Pesek wonders why "there's been **minimal backlash against this new world economic order**, save the occasional protest at meetings of the World Trade Organisation or IMF." He suggests it is because of "voters and politicians alike finding comfort in knowing that **a tested economic policy maker is at the controls**."4 In

{p. 233} other words, we are happy with the rule of the central bankers, because we believe this will ensure lasting economic growth and prosperity. It is a comforting belief.

When the German economy started to slow down visibly in 2001, German politicians including finance minister Hans Eichel, increasingly **felt the need to implement stimulatory policies**.5 However, just like their Japanese colleagues in 1999, they found that there was little they could do. Normally, three types of policy tools are available to governments in order to influence and stimulate an economy: **regulatory policy, fiscal policy, and monetary policy**. Since Germany, like many countries today, is **committed to deregulation, privatization, and liberalization**, there was no leeway for new regulatory intervention. Due to **fiscal tightening imposed by the European stability and growth pact**, stimulatory fiscal policy also had to be ruled out. This leaves us with **monetary policy, which is the most powerful** policy tool to influence an economy. However, **politicians had no power over it. The ECB is independent**

from any government. Thus the government had been left without any serious macroeconomic policy tool. Even if the Bundesbank, Germany's central bank, felt that it needed to act to stimulate the German economy, there was nothing it could do. **Once one of the most powerful central banks in the world, the Bundesbank has been transformed into the Frankfurt branch office of the European Central Bank**. The ECB decides German monetary policy, whether German politicians or Bundesbank staff like it or not.

The End of the D-Mark

On January 1, 2002, new paper money and coins were introduced in most of Europe. What still seemed an unlikely scenario to many observers as recently as the mid-199Os happened without major obstacles or upsets: Twelve European countries gave up their national currencies. With the introduction of fixed exchange rates in January 1999, their governments and national central banks had already relinquished all control over monetary policy to the new power center of Europe: the European Central Bank.6

Most astonishing to outside observers was the fact that **Europe's largest economy, Germany, had given up its deutsche mark**. The strong attachment the Germans had developed to their mark during the postwar era had bordered on the religious Many economists attributed the postwar German economic miracle to the stability of the mark and to the reliability of its guardian, the Bundesbank. With the demise of the deutsche mark, the history of the Bundesbank also came to an end.

British observers called it "a puzzle": "The DM became the key currency of the EMS [European Monetary System] and one of the world's major currencies; by the 1980s it was **second to the U.S. dollar in terms of the proportion of world trade that was invoiced in it**. That so much was achieved in such a relatively short time rnakes the history of the currency remarkable. What is perhaps even more remarkable is its future. That a currency which achieved so much, and which was for that

{p. 234} reason so popular with the citizens of the country that used it is to disappear into EMU [European Monetary Union] in 2002 is, at the least, surprising.... One could not but be surprised that a currency at once a cause and a symbol of Germany's recovery should be abandoned in a democracy."7

The Primacy of Politics

Economists knew all the while that **there was no good economic rationale for abandoning the mark**. Many of the economists at the large German banks, for instance, wanted to issue warnings about the costs and dangers to Germany of the introduction of the euro. However, the boards of their banks did not allow them to publish such research. To the contrary, **only positive analyses were allowed to be published**.8 There can be little doubt that **the reasons for the creation of the euro were not to be found in the realm of economics**.9 **Monetary integration had been used as a tool to accelerate the unification of Europe** and push toward the establishment of a fully fledged "United States of Europe."10

Despite the public information campaigns and the occasional muffling of intellectual opponents of the euro, grassroots resistance to the single currency remained strong in many major European countries, including Germany and France. Opposition is probably still strongest in **the United Kingdom**, whose population is **aware of the inevitable loss of sovereignty** and control over its destiny **if it gives up its own money. Referenda held in Denmark and Sweden were uncomfortable for politicians, because the population turned out to have a different opinion** than they did. Thus they will be asked to vote again and, if necessary, again after that. It would also have been difficult for any referendum in Germany to achieve a majority in favor of the **abolition of the mark** and the adoption of the euro. That is why **no such referendum was ever held**. Instead, politicians used taxpayers' money to fund expensive publicity campaigns to make the euro popular.

Power in the Hands of a Few

The area where the euro is used includes a population of about 290 million, with a GDP of more than E7 trillion. This closely rivals the United States, with a population of about 280 million and a GDP of about E8 trillion. The handful of decision makers at the European Central Bank control the amount and ultimately also the allocation of money circulating in the twelve countries in this region.11 This is no small matter. History has shown that **the power to create and allocate money easily rivals, and usually dominates, military might**.

Yet the often dismal performance of politicians has convinced many observers that it may be **preferable to hand power over to objective technical experts, such as the central bankers**. There are several problems with this argument. First, **even technical experts are humans**. As such, they are as **prone to errors and acts of selfishness** as anyone else. What they need is the right incen-

{p. 235} tive structure to limit these tendencies. This means meaningful accountability for their policies. Second, are central bankers really always objective? In the words of the chair of the economic and monetary committee of the European Parliament, the German Christa Randzio-Plath, "monetary policy is never neutral. It affects growth and employment."12 That is why, before the establishment of the ECB, Randzio-Piath was pushing for greater transparency and accountability of this institution - in vain, as it turns out. Especially given Europe's - and Germany's - disastrous experiments with unaccountable and opaque control regimes in the twentieth century, it is astonishing to find that yet another experiment with centralized control is being attempted. How was it possible that such enormous power over such a vast region has been handed to such a small number of people?

For the Sake of Low Inflation

The European Commission, an unelected group whose raison d'etre is to build a United States of Europe with all the trappings of a unified state, had an interest in weakening individual governments and the influence of the democratic parliaments of Europe. What better way than creating an independent European Central Bank? What is not so easy to see is why Europe's **parliamentarians** should have agreed to their own castration, which the creation of central bank independence entailed.

They **agreed because they believed that economic theory as well as historical reality had proven this to be the best solution**. Just as in Japan's case, the creation of the strongly independent ECB was **justified with the argument that this was the "human wisdom nurtured by history,"** to use Mieno's words - especially the history of the Bundesbank.

Indeed, the German experience with the Bundesbank has been largely positive. But as we see from this book, that is the exception in the relatively short history of central banks. The experience with the Bundesbank's predecessor and with the central banks of other countries has not been as happy. This raises three questions: **What made the Bundesbank so successful? Is the same ingredient for success also to be found with the ECB** (and the Bank of Japan and other central banks)? What, indeed is the definition of "successful" monetary policy?

Inflation is usually considered the main policy mistake that central banks or governments can commit. Pundits have boiled the message down to the formula that **central bank policy is successful if there is little inflation**. Indeed, during much of the postwar era, German inflation has been modest by international comparison The same commentators usually argue that the main ingredient of the Bundesbank's success of low inflation was its independence. This view has become accepted wisdom, so much so that we hardly ever ask whether there is any real evidence for it.3 Several influential academic studies have offered such evidence showing statistically that the degree of independence of a central bank is

{p. 236} correlated with lower inflation. The less influence governments can exert over central banks, the more stable the currency, they say.

It turns out that **the scientific evidence for central bank independence that was relied upon in the Maastricht Treaty derives from a single study that was commissioned by none other than the European Commission itself** - an interested party. Published in 1992 under the name "One Market, One Money," the study purported to demonstrate that central bank independence leads to low inflation.14

Phony Findings

How reliable are the findings of this study? **A closer look reveals that there is no such scientific evidence**. The study arbitrarily selects a number of countries, then arbitrarily determines the degree of independence of their central banks and then finds that this is correlated with the past inflation performance of the country concerned. **There were no tests to determine whether the results vary if one uses a different time period for the average inflation than the one chosen by the authors**. There were no tests to demonstrate whether a different selection of countries, other than the seventeen picked by the study, would yield a different result.15

Most damning, however, is the methodology employed to determine the degree of central bank independence of the countries that were examined. **Since there is no official index of central bank independence, the authors set out to create one**. James Forder, an independent economist at Oxford University, has examined whether the researchers carefully followed their own definitions of independence and hence were at least internally consistent in their argument - the most basic and necessary (but not sufficient) requirement for scientific research.16

His findings are shattering. He uncovered a **string of manipulations of the data** by the original authors, which happen to produce the desired answer that a high degree of independence is associated with low inflation. **Correcting for these apparent "mistakes,"** Forder finds that some of the data points from the countries most crucial for obtaining the result suddenly differ. After his correction, **no more statistically significant correlation could be detected between independence and inflation**. Forder's conclusion: The data and method used by the economists commissioned by the European Commission do not provide evidence of any relationship between central bank independence and inflation.

The European Commission used this flawed study as the main argument for the introduction of the Maastricht Treaty of 1992, which signed Europe up for rule by the ECB under a single currency.17 We must conclude that statistically no robust link exists between central bank independence and low inflation.

Not by Low Inflation Alone

But we saw that inflation is not the only example of central bank policy mistakes. Japan's inflation rate has been lower than the German one for the past decades.

{p. 237} Hence **by the traditional definition of the success of monetary policy, the Bank of Japan beat even the highly respected Bundesbank at its game**. Japanese consumer price inflation averaged 1.5 percent in the last twenty years, compared to 2.5 percent in Germany. Consumer price inflation even turned negative in the late 1990s, averaging 0.8 percent during the decade (compared to 2.3 percent in Germany). **Yet we all know that Japanese monetary policy cannot be called a success over the last decades.** This proves the point that **low inflation must not remain the only way to measure a central bank's achievements**.

There are many other serious problems that central banks can create, such as recessions. In this case, inflation may be low, but the economy may suffer from **large-scale unemployment** induced purely by monetary policy. Central banks can also create **deflation, which increases the real debt burden of borrowers**, such as homeowners with mortgages. This is what happened in Japan and several Asian and Scandinavian countries. Again, by the measuring rod of low inflation, the central banks would have been doing a good job. But in reality they were not doing their job at all.

Central banks can also cause excessive speculative booms through their policies. That is the story of the United States, the Scandinavian countries, Japan, and most of Asia, where **asset booms were accompanied by stable consumer price inflation**. Once again, if measured solely by low inflation, central bankers seemed to be doing their job. But **asset inflation stored up enormous trouble for the future,** ultimately causing the bankruptcies of a large part of the corporate sector and pushing the economy into recession and high unemployment.

Independence Does Not Guarantee Good Policies

There is no evidence that the central bank policies leading to asset inflation and then deflationary recessions in the above countries were determined by other actors, such as governments. Instead, they were made by central banks that were largely independent from government interference concerning their crucial credit quantity policies. This shows that central bank independence alone does not guarantee economic success of monetary policy. The Swedish Riksbank, for instance independently created a credit boom in the 1980s and a credit crunch in the 1990s. The **U.S. central bank leadership was not influenced by political pressure when it increased credit creation steadily throughout the 1990s**, thus **creating a vast asset bubble**. The central banks of Thailand and Korea independently encouraged their banks to lend excessively to the real estate sector and independently set policies that encouraged their entire corporate sectors to borrow from abroad, thus placing a precarious time bomb at the heart of their economies.18 After this they took excessively tight policies, creating deep recessions.19 This happened against the will of the respective governments. Most of all, the Bank of Japan acted independently when it forced the Japanese banks to create the 1980s asset bubble and then independently prolonged the subse-

{p. 238} quent **ten-year recession of the 1990s, which brought down the once mighty Japanese economy.**

By comparison, the Bundesbank did a reasonably good job also by **our broader definition of success, as unemployment**, while rising especially in the mid-198os and late 1990s, remained significantly below that of other European countries.20 Economic growth was fairly high throughout the postwar era, clocking up over 6 percent in real terms in the 1950s and 1960s, and averaging 2.7 percent in the 1970s, the 1980s, and again the 1990s. This is among the best of all industrialized countries. Moreover, there has neither been a deflationary credit crunch nor a nationwide asset bubble based on excessive speculation in financial investments in Germany - as happened in so many other countries the world over.

We learn two things. First, **the measure of monetary policy success** must be more than inflation, namely, **the combination of low inflation with stable and positive economic growth**. As we saw in chapter 4, **growth is largely determined by the central banks, because only the creation of new purchasing power enables new growth**. Central banks can manipulate their own credit creation as well as that of the private-sector banks. Increased credit creation pushes up nominal GDP. The link to inflation is simple: Growth will remain without inflation until the economy reaches the maximum potential growth rate. Credit creation beyond that may produce inflation if the newly created money is used for unproductive purposes. But whenever growth remains below the maximum potential growth rate, creating additional credit does not necessarily produce inflation.

Second, the main reason for the high esteem that is accorded to the Bundesbank by the German population is its growth orientation. If the German central bank had pushed Germany into ten years of deflation, very few commentators would have considered its policies a success despite the absence of inflation. So the crucial question is this: **Did the Bundesbank achieve its policy combination of low inflation and high growth thanks to independence from the government?**

The Reichsbank Was Also Independent

Many economists who argue that the Bundesbank's success was due simply to legal independence from the government forget that **even the Bundesbank's prewar predecessor, the Reichsbank, was legally independent** from the government. This independence existed to a great extent de facto since its foundation in 1875, because **the central bank was largely privately owned and accountable to the shareholders**.2l **Independence was explicitly written into law in May 1922 and lasted until 1939**.2 **Until then the Reichsbank was not accountable to the people, the government, or parliament**. In August 1924, a new banking law again confirmed the Reichsbank's independence from the government - "but greatly increased the **influence**over the central bank **of Germany's foreign creditors**."13 **The Reichsbank was independent from German democratic institutions, but dependent on the will of interests outside Germany**. While the government could do nothing about

{p. 239} Reichsbank policies, **the central bank was under the control of the Reparations Commission which was dominated by Wall Street bankers**.24 Needless to mention, the interests of these Wall Street firms were not necessarily identical with those of the German population.

During this time, **the Reichsbank was far more independent** than the Bundesbank. It was also not accountable for its policies. Yet what did this highly independent central bank do? **It did much to undermine the fledgling Weimar democracy**. First, it produced hyperinflation, which started in earnest in mid-1922 and peaked in late 1933 with consumer prices rising two-billion-fold. From the mid-1920s until 1933, the Reichsbank adopted highly restrictive policies. The first phase of credit tightening, between 1924 and 1926, was followed by an even worse credit crunch in 1931. In both periods, thousands of firms failed to obtain funding and went bankrupt. As we saw, for most of this time **the power of life or death over firms was in the hands of Reichsbank president Hjalmar Schacht**. He implemented extralegal credit controls over the banking sector of the type that we examined in great detail in this book. He used them to **engage in the active transformation of the German economy by forcing the bankruptcies of many firms** - a process he described as having **a "cleansing" effect**. His declared goal was to **accelerate "rationalization,"** a process that today's central bankers refer to as **"restructuring" or structural change**.25

W**hen U.S. banks pulled their deposits from German banks in the aftermath of the U.S. credit crunch that began in 1929**, **the Reichsbank insisted that the banks call in their loans to German industry** to pay the U.S. depositors. As had always been expected, industry had invested the money in plant and equipment. The policies of the independent Reichsbank meant that **firms had to close down and sell their assets at distressed sales prices**. Overnight, mass unemployment was produced. Germany was thrown into the Great Depression. For those who trust that such disastrous policies will never be repeated (surely central bankers learn from past mistakes?), chapter 17 demonstrated that **the central banks of Thailand, Korea, and Indonesia** virtually c**opied the extraordinary policies of the Reichsbank in the 1920s and early 1930s - resulting in the Asian crisis of 1997 and 1998**, which also brought down governments and created record high unemployment. In a further parallel to events of the 1920s, **international bankers, this time represented by the International Monetary Fund, demanded deep structural changes** from these Asian nations.

The economic instability that doomed the Weimar Republic was due not only to the unreasonable demands of the victors of the First World War. It was at least as much the result of an unaccountable central bank that had excessive powers. Germany's first democracy had little chance: The government could try to create economic growth, but ultimately the power over the economy was in the hands of the central bank. Economists concluded that the Reichsbank had become a "second government" (*Nebenregierung*) that acted "dictatorially" and independently from the elected government.26 The democratically elected government was the less powerful one.

{p. 240} Trust Us, We're Central Bankers

Being independent from the German government did not prevent the Reichsbank from adopting the horrific policies of the 1920s and early 1930s that ultimately proved fatal for Germany and the world, as they set the **stage for the arrival of a pro-growth party, the NSDAP**. We must remind ourselves that **arguing in favor of independent central banks is effectively to say that politicians cannot act in the national interest**. Only central bankers, neutral and objective technical experts, can make decisions for the benefit of the people.

No doubt this is a cynical view of democracy as a system. **It was also the view taken by the NSDAP**, which argued that politicians could not be trusted. It is a view that is not without dangers, for it turns technocrats into the rulers of our countries - a form of technocratic totalitarianism. The evidence suggests that this approach is naive. The highly acclaimed monetary technician **Hjalmar Schacht**, for one, **used his skills and legal powers to actively and purposely hand Germany over to Adolf Hitler**. He was rewarded for his services by being reappointed as head of the Reichsbank from 1933 to 1939.27

So can we expect the ECB to act in the interests of the people? The first difficulty is to identify just who those people are. The ECB makes monetary policy for twelve quite diverse economies. **One size of policy shoe must fit all European feet**.28 The even bigger problem is that there is no guarantee that the central bankers at the ECB are as all-knowing and benevolent as we would like them to be. So far there are few historical examples of societies that are successfully governed by a small group who are largely unaccountable for their actions. Given the enormous power that we have given into their hands, it should not surprise us if and when thls power is misused.

Accountability Is Key

Back to the puzzle - why was the Bundesbank successful? Ultimately, people react to incentives. **The incentive structure is usually defined by the institutional framework, and that is normally prescribed by the legal structure**. So the Bundesbank's legal setup should give us some indication about what makes a good central bank. We notice that legally the Bundesbank was not just required to work toward price stability. **In 1967, ten years after the founding of the Bundesbank**, the parliament passed **the Stability and Growth Act**, which clearly **set out the objectives of its policy as "price stability, a high level of employment, external equilibnum, steady and adequate economic growth."** The law mandated the Bundesbank to produce low inflation and stable growth. This was also what the Bundesbank had in mind when it made its policies. Bundesbank president Klasen, for instance is sald to have "accorded economic growth equal priority to monetary stability."29

The Bundesbank is often talked about as having been the most independent central bank in the world. This is simply not true. In reality, the independence of

{p. 241} the Bundesbank was clearly limited. To start with, **central bank independence was not enshrined in the constitution and was thus not irrevocable**. Moreover, the Bundesbank was only given "independence from government instructions." When this was formulated, the lawmakers, presumably remembering the lessons from Weimar explicitly warned that this phrase "of course must not be interpreted to mean that the central bank become a state within the state."30 **While being independent from direct instruction from the government, the Bundesbank was not independent from the parliament**, which could pass laws or give instructions if it so wished. Moreover, it was not independent from other institutions of the Federal Republic but was **subject to German laws and was accountable to the federal audit agenc**y (the Bundesrechnungshof) and the decisions of German law courts.

But even the independence from the government was limited, for the Bundesbank Law also said explicitly that **"it is the duty of the Bundesbank ... while fulfilling its tasks to support the general economic policy of the Federal Government."** And there is virtually no time period when the government's main policy aim was not to achieve decent economic growth. Despite the inability to give direct instructions to the central bank, **government representatives could join the policy board meetings of the Bundesbank and expect the bank to support their policy objectives of near-full employment.** As legal experts point out, if the government placed a different emphasis among the goals of the Stability and Growth Act than the Blmdesbank - for instance, by pursuing economic and employment growth - then **as long as price stability was not neglected, the Bundesbank was obliged to follow the policies of the government**. Ignoring the goals of the Stability and Growth Act would have been illegal.3l

There were other incentives embedded in the legal structure that helped make the Bundesbank successful. For instance, the Bundesbank had a decentralized structure that included in policy decisions representatives of the German states, appointed by the Bundesrat. Moreover, each regional representative was in turn advised by representatives of the various occupations, including trade unions.32 As a result, the decision-making process of the Bundesbank was usually well balanced, reflected the various parts and regions of society, had to take government policy into consideration, and was subject to legal checks and balances.

This multifaceted accountability and consensus orientation produced the Bundesbanks fairly successful monetary policy. Of course, there were also mistakes And the Bundesbank had enough power to cause serious problems for politicians There are many instances where the government would have liked it to stimulate the economy more, but the Bundesbank refused. The downfall of three Chancellors - Ludwig Erhard in 1966, Kurt Georg Kiesinger in 1969, and Helmut Schmidt in 1982 - was directly or indirectly linked to tight Bundesbank policies. Often the government, not the Bundesbank, turned out to be right.34 But ultimately there were political limits on the Bundesbank's ability to go it alone against the interests of the population.35

Ironically, we must therefore conclude that **the success of the Bundesbank was**

{p. 242} **due less to its independence than to its subtle dependence on the other elements of the democratic system**. The legal setup made the central bank highly accountable for its policies, and it was always clear that these policies could not consist solely of producing low inflation, but instead had to reflect the goal of stable economic growth. By contrast, **the Reichsbank's failure was surely due to its excessive independence without accountability and recourse**. Thus, comparing the Reichsbank and the Bundesbank, we find that the reduction in central bank independence and the introduchon of accountability and dependence on democratic institutions that was undertaken in the postwar period greatly enhanced the performance of monetary policy. Contrary to popular opinion, the Bundesbank's success was due to its comparative lack of independence.

Thus in order to determine whether the ECB is going to be successful as far as the German and European people are concerned, it is crucial to determine whether the new central bank is similarly accountable to the people to implement the twin goals of low inflation and stable growth.

The Unaccountable ECB

With the introduction of the ECB system, **the German government has lost its influence over monetary policy**. With the creation of the ECB, the Bundesbank Law was also revised. In the new Bundesbank Law the German central bank not only became subject to the ECB instructions, but also is **no longer required to support the general policies of the government.36 Neither is the ECB required to support the policies of the German government. It is, however, required to support the "general policy goals of the EU."** The Maastricht Treaty, which defines the role of the ECB, says that the ECB has a primary mandate to maintain stable prices. It also says that "where it is possible without compromising the mandate to maintain pnce stability," the ECB will also support the "general economic policy of the EU, whlch minludes among other goals **"steady, non-inflationary and environmentally frlendly growth"** and **"a high level of employment."**37

This could be interpreted to mean that the ECB, like the Bundesbank, has to work for the twin goals of low inflation and stable economic growth. However, the emphasis is explicitly on price stability. Moreover, **unlike in the case of the Bundesbank, there are virtually no checks and balances on the actions of the ECB**. It is therefore practically impossible for anyone - for instance, a government, parliament, or even the **(unelected) EU Commission** - to enforce any specific goals or, for that matter, enforce anything at all. Unlike the Bundesbank, the ECB is independent not only from the government but also from parliaments, democratically elected assemblies, or other institutions within the EU. Moreover, the Maastricht Treaty, defining the ECB's status, includes the clause that **no democrahc instltutlon within the EU is even allowed to attempt to influence the policies of the ECB.**38 This is unprecedented among democracies.

In addition, the ECB is far less transparent than the Bundesbank was. For in-

{p. 243} stance **the deliberations of its decision-making bodies are secret**.39 It is not required to publish detailed information about its transactions (this requirement was also scrapped for the Bundesbank with the establishment of the ECB). While it has the power to obtain data from any bank or company in the EU, the ECB is not obliged to publicize that data or any specific statistics. Not surprisingly, the ECB's statutes are already being interpreted as virtually exclusively aimed at price stability. Wim Duisenberg, when he was head of the ECB's predecessor organization, the EMI, told us that he favors "a single monetary policy which strictly aims at price stability in the euro area as a whole."40

Resurrection of the Reichsbank

The ECB is far more independent than the Bundesbank has ever been. It is **also much more independent than the U.S. central bank, the Federal Reserve**, whose legal status is far weaker and w**hich is directly accountable to Congress and the government**.4l We find that the ECB is the least accountable central bank among advanced nations. We must conclude that there is a danger that the incentive structure of the staff at the ECB is not sufficient to guarantee optimal economic policies. This is worrying. It suggests that the lessons of German history were not interpreted correctly and the ECB was created on the wrong foundations. Instead of adopting the features that made the Bundesbank successful - accountability and interdependence with other democratic institutions - the creators of the ECB revived the corpse of the unaccountable Reichsbank. As we saw, the story line of human misery runs quite directly from Schacht to Ichimada, who had trained with the "financial wizard," and the princes at the Bank of Japan who created the recession of the 1990s. History tells us that it is dangerous to deliver vast powers without checks and accountability into the hands of a few unelected officials. "Human wisdom nurtured by history" suggests not to revive the Reichsbank. But the creation of the ECB did just that.

Oversteppjng the Boundaries of Monetary Policy

The Reichsbank in the 1920s was engaged in policies that went beyond the boundaries of standard monetary policy. It engaged in structural policies and forced "rationalization" of industries. The experience of Germany during the Weimar republic shows that Japan is not the first country that is being coerced by an independent Central bank into implementing deep structural reforms and "restructuring." Nor is it the last, as the experience of Eastern European, Latin American, and Asian countries under IMF tutelage shows. Their central banks, probably thanks to the allure of legal independence that the IMF promised, in almost all cases supported the IMF's arguments. Recessions and large-scale economic dislocation followed. Surely the ECB would not do such a thing in Europe?

{p. 244} When German politicians, including the finance minister, hinted in summer; 2001 that further stimulatory policies would be needed from the ECB to support growth, ECB president Wim Duisenberg and his colleagues repeated what the Financial Times describes as their "monthly mantra": calls for fiscal tightening and structural reform. During its short history, t**he ECB has consistently refused to create more money to stimulate the German and European economies until** its conditions are met, namely, that **the German and other governments implement structural changes**: "Wim Duisenberg, president, and his colleagues have turned calls for fiscal discipline and structural reform into a monthly mantra. These demands have been the implicit price for an easing in monetary policy."42 These structural changes include **liberalization, deregulation, and privatization - in short, the introduction of neoliberal U.S.-style shareholder capitalism** and the abolition of the well-established and successful welfare capitalism.

The parallels with Japan are disturbing. **What if the ECB has already decided that the postwar German-style economic system is bad and must be scrapped?** It ordered the Bundesbank to shrink its credit creation by record amounts in 2002. **As the amount of money circulating in the economy shrank, demand fell and the economy moved into recession**. Parallel with this, the central bank stepped up its **claim that the German recession is due to its outdated economic structure**. Most observers would find it hard to prove otherwise. As the recession continues, more and more experts would likely agree - all they can see is a long recession. Surely that proves that the system does not work?

Slow Growth Due to the System - or Monetary Policy?

Japan built its postwar economic system on the German model of economic development, pioneered by German economists and implemented by policymakers in the first half of the twentieth century. The system has been highly successful in achieving fast growth, the rapid overall development of the economy, a sharp rise in incomes and living standards, and a surprisingly equal distribution of incomes and wealth. In Germany, Ludwig Erhard, a proponent of the concept of a "social market economy," undertook the postwar modification of this system. The aim was to combine a market economic structure with clever government guidance slmilar to what happened in Japan. There can be no doubt that **the German and Japanese system of economic development has been highly successful and especially beneficial for the average citizen.** It can serve as **a model for developing countries.**

However, this is not happening. To the contrary, **both Germany and Japan are being asked by the central banks, as well as** the institutions of **the "international community"** (such as the **IMF** and the **OECD**, as well as the **ECB** and the **U.S Treasury), to implement deep structural reforms**. The German-style system, we are told, is bad and inefficient. The entire system needs to be scrapped, together

{p. 245} with the economic and social structures that it spawned. What is good for efficiency, we are told, is unmitigated U.S.-style capitalism.

No Serious Debate

This may well be a worthwhile undertaking. I would, however, like to take issue on several grounds. First, the question of whether an entire economic (and hence also social) system should be changed affects such large parts of society that in a democracy a **wide-ranging public debate** and far-reaching policy discussions are normally preconditions. This debate should follow the standard procedures of the democratic decision-making process and should include a discussion of the advantages and disadvantages of the German-style economic system, comparing them to the costs and benefits of U.S.-style capitalism.

Let us not forget that Ludwig Erhard and the intellectuals around him, as well as their colleagues in Japan, were fully aware of the features of U.S.-style free market capitalism. Yet they purposely chose a different system. They must have had some good reasons. The fact is, **U.S.-style capitalism has major disadvantages** that will not be popular in European countries. Among these are **income and wealth disparities so wide that they otherwise exist only in developing countries, greater educational inequality, far larger social instability, and far higher crime rates** - in other words, a society that European thinkers in the past have considered but rejected as inequitable and socially unjust.

Nevertheless, whether German citizens wish to adopt this system or not is ultimately a choice that they should make for themselves. After a suitable public debate, the voters and their representatives should make a considered decision. This, however, is not bappening. It seems that **such decisions are nowadays made behind closed doors by central bankers.**

Second, **it is not clear that the adoption of U.S.-style deregulation and U.K.style privatization is the only solution for Germany.** The German system has many worthwhile features that could be preserved, as does Japan. **Would it not be better to renovate what is outdated, while leaving the structure in place?** That, certainly, is more in line with European tradition.

Third, the reasons why Germany and Japan's economic systems are being criticized are suspect. There is little evidence to suggest that changing their economic structures radically and introducing U.S.-style capitalism will lead to higher economic growth. **If Germany's economic structure is indeed the cause of low growth, why did Germany experience much higher growth in the early 1990s and 1980s, before the structural reform policies** implemented over the past five years or so? If the German-style economic structure is so inefficient, how come it produced 8 percent real GDP growth in the 1950s? Moreover, if the U.S.-style economic system will lead to an economic recovery, how come the United States itself moved into recession in late 2001, or ten years earlier? Clearly, the U.S. System also has business cycles. This proves that another factor besides the eco-

{p. 246} nomic structure explains economic growth. That factor is money. And **money is controlled by the central banks**.

Misuse of Central Banking Power

Those in favor of central bank independence argue that central bankers should be put above politicians and governments because they are objective and not political. But the history of central banking is littered with examples of central banks overstepping their powers and engaging in highly political decisions.

The founding fathers of the United States of America were well aware of that power of banks and banking dynasties. They therefore categorically resisted the establishment of a central bank. Thomas Jefferson was a vehement opponent of central banks. **The U.S. Constitution** therefore **enshrines the right of the government to issue money. It leaves no role for a central bank**. This is why for a large part of its existence the United States did not have a central bank. Money was issued by the government or by banks in a system of free, competitive banking. America did not fare badly without a central bank: It was the fastest-growing emerging market at the time and by 1900 had just about overtaken Britain, the world's number one economic power.

The Federal Reserve was founded only in 1913 and remains **half privately owned**. A reluctant Congress was finally persuaded to agree to its establishment based on the argument that the central bank could step in and bail out banks when a banking crisis occurs. But when such a banking crisis did arrive in the 1930s (triggered by the Fed's very own policies of excessive credit creation), **the Fed failed to act**. Hundreds of thousands of farmers lost their land and livelihoods. **The Great Depression changed the face of America. Yet the Fed has never been held accountable** for its policies.

Lessons from Japan

Given the enormous dangers, many ordinary citizens have protested against the creation of the ECB and the scrapping of the mark. Several German politicians refused to become Mitlaufer (those who "go with the flow") and dared to speak up against the growing tide of high-level political support for the euro. Oskar Lafontaine, for instance, argued that the ECB needed more democratic checks and balances on its policies. Implementing such checks does not mean that money should be debauched and inflation allowed. To the contrary, the only guarantor of stable money is accountability of a central bank that has been given suitable policy goals. The lessons of the Reichsbank and of the Bank of Japan are also the lessons of the ECB.

Like the Reichsbank during the Weimar Republic, the Bank of Japan has been the true government of Japan. The threat remains that the ECB is following closely in the footsteps of these dictatorial central banks.

{p. 247} Global Rule of the Princes

Unfortunately the situation is not significantly different in the United States. No one disputes the power of the Fed to move markets and the economy. Yet this power is used without many actual democratic checks and balances. **Whenever Fed chairman Alan Greenspan gives an account** of his policies and actions **to Congress he says little of interest (and is even commended for it by the press)**. Nobody monitors and imposes limits on the amount of credit the Fed is creating. Thus **Greenspan**, through his interest rate policies, **has publicly given the impression that he wanted to slow the economy** most of the time from the mid-1990s onward, such as with his famous 1996 speech on "irrational exuberance." **The fact is, however, that he has continued to increase the credit creation of the Fed during this time**.43 This was **exactly the reverse of the policy taken by the Bank of Japan in the 1990s**. While the BoJ publicly wanted to demonstrate that it was doing all it could to reflate the economy by lowering interest rates, the truth of its policy intentions was revealed by its quantitative policy: It failed to reflate for most of the 1990s. Likewise, **Greenspan has expressed surprise at the strength of the U.S. economy. But whenever he raised rates, he accelerated his printing of money**. The Fed has moved the economy through its quantity policies while focusing its public statements strictly on interest rates in the same way as Japan.

The Yoke of the Princes

The current power of central banks is difficult to reconcile with democracy. As long as central bankers continue to exert unchecked control over the quantity of credit and its allocation, they are the undisputed rulers of the economy. If they have such powers, they are likely to use them. This probably means the continuation of the boom-and-bust cycles engineered by central banks in the pursuit of their goals. And these goals may be quite different from what we may naively assume. As long as there is no meaningful accountability, people's lives are but puppets in their credit game. To strengthen democracy, policymakers will have to consider changing the laws again, to make central banks accountable to parliaments for their policies - and this means their quantitative policies. Alternatively, we should heed the conclusion Milton Friedman came to after decades of research and experience dealing with the Federal Reserve: "The only two alternatives that do seem to me feasible over the longer run are **either to make the Federal Reserve a bureau in the Treasury** under the secretary of the Treasury, **or to put the Federal Reserve under direct congressional control**. Either involves terminating the so-called independence of the system. But either would establish a strong incentive for the Fed to produce a stabler monetary environment than we have had.44

{p. 272} Another way to increase credit creation is for the **central bank to create money and transfer it to each taxpayer** in the country. Unlike tax reductions, this present would constitute monetary policy and hence **not crowd out private activity**.

{p. 275} {text accompanying Figure A.5} **Fiscal Stimulation by Bond Issuance**

During the 1990s, most **fiscal spending was funded not through money creation, but through borrowing from the private sector** {by selling Government Bonds}. Such fiscal spending must crowd out private activity. Fiscal policy becomes a zero-sum game that merely reallocates existing resources. {end text accompanying Figure A.5}

{text accompanying Figure A.6} **Fiscal Stimulation by Bank Borrowing**

Government spending not backed by credit creation (monetization) crowds out private-sector activity. The central bank can monetize (for instance, through bond purchases), but so can the government: By **shifting government funding from bond issuance to bank loan contracts**, bank credit creation increases. Unlike fund raising via the capital markets, **borrowing from banks will not withdraw purchasing power** from other parts of the economy, **as banks can create new money out of nothing.** {end text accompanying Figure A.6}

{end}

(2) Reply to *Princes of the Yen* - by Peter Myers, January 24, 2006.

After Mao died, Deng Xiaoping visited Japan. He was so impressed that he decided to switch China's economy to the Japan Model.

Richard A. Werner, in his book *Princes of the Yen*, shows that Japan of the "miracle" days was engaged in economic warfare against the rest of the world.

Kinhide Mushakoji, an author published by the Trilateral Commission as well as UNESCO, wrote that the Asian Tigers were Japan's occluded (i.e. secret, hidden) East Asia Co-Prosperity Sphere: mushakoji.html.

George Soros wrote, in his book *The Alchemy of Finance*, "Japan has been accumulating assets abroad, while the United States has been amassing debts. ... President Reagan ... pursued the illusion of military superiority at the cost of rendering our leading position in the world economy illusory; while Japan wanted to keep growing in the shadow of the United States as long as possible. ... Japan has, in fact, emerged as the banker to the world" (1987; New Preface 1994, John Wiley & Sons, New York), p. 350.

The Asia Crisis was part of a struggle between Japanese finance (the challenger) and Jewish Finance (the incumbent), in which the latter won: asia-crisis.html.

An earlier bout in that struggle was the Basle Accord of 1988.

Most analysts assume that the bursting of Japan's bubble, from 1989 on, was a natural event, just part of the capitalist cycle.

Werner, in *Princes of the Yen,* depicts it as engineered by the Bank of Japan, with American prompting in the background.

But Patrick S. J. Cormack and Bill Still write, in their book *The Money Masters: How International Bankers Gained Control of America* (Royalty Production Company, 1998, pp. 73-4):

"{p. 73} Regulations put into effect in 1988 by the BIS {the Bank of International Settlements}, called the Basle Capital Adequacy Accord, required the world's bankers to raise their capital and reserves to 8% of liabilities by 1992. ... those nations with the lowest bank reserves in their systems have already felt the terrible effects of this credit contraction as

"{p. 74} their banks scrambled to raise money to increase their reserves to 8%. To raise the money, they had to sell stocks which depressed their stock markets and began the depression first in their countries. Japan, which in 1988 had among the lowest capital and reserve requirements, and thus was the most effected by the regulation - has experienced a financial crash which began almost immediately, in 1989, which has wiped out a staggering 50% of the value of its stock market since 1990, and 60% of the value of its commercial real estate. The Bank of Japan has lowered its interest rates to one-half of a percent - practically giving money away to resurrect the economy, but still the depression worsens".

{endquote} More at money-masters.html.

Was the Basle Accord aimed at Japan especially? Why did Japan accept it?

David Grover wrote,

'Japan's ... ability wield financial influence over the United States was actually quite limited. The U.S. still had the structural power to "set the menu" of international banking. ... pressure to pass the Basle Accord ... came from American and British bankers who claimed 'under-capitalized' Japanese banks were pinching their business unfairly. ...

'The problem facing the U.S. was to devise a strategy for placing the issue high on other states' agendas. A bilateral agreement on capital standards with Britain served this purpose nicely, as Britain shared many of the same concerns about its international bank competitiveness. Now, Japan and other countries were facing the possibility of a "zone of exclusion" disadvantageous to their international banks. Japan was now facing a unified Britain and U.S., and they were forced to come to the negotiating table. ...

'However, Japan's financial power in the late 1980s cannot simply be dismissed. Most strikingly, by 1985, it had emerged as the world's largest creditor. ... However, it is increasingly recognized that Japan's creditor status has not in fact brought an enormous increase in power to the Japanese State. The biggest limitation on translating this creditor status into power is that the majority of funds have been lent to a country - the United States - on which Japan is heavily dependent, both militarily and economically ... '

See David Grover's analysis at basle-acord.html.

That's where the Multi-Function Polis (MFP), a city Japan wanted to build on the Gold Coast in Australia, came in; it was to be Japan's capital here, an extraterritorial city not bound by Australian law. Australia was to be the new Manchukuo, giving Japan the raw materials and space to achieve independence from US domination: mfp-saga.html.

After the MFP was rejected, Japan proposed building a city called Pacifica in Western Australia, in the Great Sandy Desert, south of Broome; it was to be the headquarters of the whole Asia-Pacific region: pacific.html.

Just as I cannot side with either the US or China in their coming dispute, so I cannot side with either the US or Japan in their past one.

But let us not delude ourselves that it was going on. The West has its own forms of occluded power structures even more sophisticated than those of Japan Incorporated.

Werner's book *New Paradigm in Macroeconomics* is welcome:
http://www.palgrave.com/economics/monographs/, but has some omissions.

Here's a clue. Werner writes,

"Samuelson's nephew, Lawrence Summers, is another example of a successful neoclassical economist who made it into highest government office."
http//www.palgrave.com/pdfs/1403920745.pdf.

Both are Jewish - yet Werner is innocent of this factor. Samuelson, whose textbook on Economics has long been the standard training manual in universities, is listed among Jewish economists: http://www.jinfo.org/Economists.html.

Others listed there include Stanley Fischer, Milton Friedman, Alan Greenspan, Paul Krugman, Ludwig von Mises, Ayn Rand, Murray Rothbard, Jeffrey Sachs, Joseph Stiglitz, Lawrence Summers.

Lawrence Summers is Jewish: http://www.yucommentator.com/v67i4/israelcorner/address.html.

"Indeed, I was struck during my years in the Clinton administration that the existence of **an economic leadership** team with people like Robert Rubin, Alan Greenspan, Charlene Barshefsky and many others **that was very heavily Jewish passed without comment or notice** -- it was something that would have been inconceivable a generation or two ago, as indeed it would have been inconceivable a generation or two ago that Harvard could have a Jewish President."

Would the media have noticed if Clinton's cabinet had been Islamic instead?

It is astonishing **how many of the key players in the Asia Crisis were Jewish**:

Jewish Hedge Fund managers: George **Soros**, Warren **Buffet**, Michael **Steinhardt**.

Clinton's cabinet: **Madeline Allbright** (Secretary of State, i.e. Foreign Minister), **Robert Rubin** (US Treasurer), **Mickey Kantor** (Secretary for Trade**,** in charge of GATT and WTO), **William Cohen** (Secretary for Defence), **Sandy Berger** (National Security Adviser)

Alan Greenspan was head of the Federal Reserve. Martin Wolfensohn was head of the World Bank (now succeeeded by another Jew, Paul Wolfowitz). **Stanley Fischer was running the IMF** (as Chief Economist there; in 2001 he became Governor of the Bank of Israel).

Paul Krugman was writing articles deriding the Japan model.

The Asia Crisis as a struggle between Jewish finance and Japanese finance: asia-crisis.html.

{end}

Buy *Princes of the Yen* new at http://www3.addall.com;

order second-hand copies at
http://dogbert.abebooks.com/abe/BookSearch?an=richard+werner&tn=princes+yen

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