2D. The Growth And Problems Of The Global Economy

- Reasons for the growth of the global economy
- Problems that affected the growth of the global economy e.g. oil crisis, protectionism versus free trade, trade imbalances, debt crisis
- Reasons for the dominant role of USA in the global economy
- Japan’s ‘economic miracle’: reasons for Japan’s economic success and its problems
- Rise of China as an economic power in the post-Mao era

JAPAN’S ECONOMIC PROBLEMS

1. Problems of an export-oriented country
   - Heavy reliance on imported raw materials
   - Dependence on access to foreign markers
   - Rise of Yen; Erosion of competitiveness

2. Structural Problems
   - Rigidities of big conglomerates
   - High costs of life-time employment
   - Prolonged banking crisis
   - Economic stagnation

3. 1980s – ‘Bursting of the Bubble’
   - Domestic speculative frenzy
   - Over-valued asset prices
   - Loan defaults and bankruptcy
   - Prolonged recession

Problems of an export-oriented country

A) Heavy reliance on imports of raw materials made Japan susceptible to recession and inflation caused by the oil crises in the 1970s
   - Of all the industrialized economies, Japan was by far the most dependent on oil to sustain its economy. This was due to the expansion of heavy industries and the development of new industrial estates along the coastal fringe of Japan which made Japan’s resource-poor economy more dependent than ever on the imports of raw materials, e.g. iron ore, bauxite and crude oil.
     - Fully three-fourths of its national energy requirements were satisfied by oil imports.
   - Hence, the 1973 OPEC oil crisis saw inflation soar well into the double digit range as a speculative panic took hold in the country.
Furthermore, cut in the use of oil pushed the economy towards recession and a shortage in state tax revenue, which forced the state to abandon the welfare state.

- Japan’s GDP in 1974 showed a decline for the first time after the war.

- In other words, heavy dependence on raw materials rendered Japan vulnerable to external pressures/crisis, such as the oil shock of 1973 that dealt a huge blow to the Jap economy.

B) Dependence on access to foreign markets (due to culture of thrift) rendered Japan vulnerable to external crises e.g. the AFC

- One problem in the Japanese economy by the beginning of the 1990s concerned the high rates of personal savings and consequently low levels of consumer demands (CULTURE OF THRIFT)

  - Sapped the core strength of the domestic economy -> Japan had to rely on access to foreign markets.
  - By 1983, the ratio of Japan’s exports to GNP had risen to just over 15%

- Hence the 1997 Asian Financial Crisis dealt a huge blow to Japan and was the major external factor responsible for Japan’s economic downturn.

  - It affected many markets of importance to Japan e.g. SK, HK, Thailand, Indonesia, Malaysia and Singapore and worsened the Japanese economy by reducing export demand.

  - Worse, in light of the recession, the government could not make the classic response of cutting taxes in order to stimulate demand.

    - Led to collapse of 3 major Japanese banks which aggravated the decline of the Jap economy, which registered a 2.5% GDP decline in 1998.

C) Rapid appreciation of the Yen resulted in the erosion of Export Competitiveness

- Background: Initially, Japan was able to build up its economy in the late 1960s due to the pegging of the ER to exactly 360 yen to the dollar. This gave Japanese exporters a strong cost advantage in countries such as the US. In early years, weak yen had not been a serious threat to the US industries which were going through their own boom years. By the early 1970s, it was clear that the rapidly strengthening economies of Europe and Japan no longer justified an artificially strong dollar relative to their currencies.

- Hence, for a period in 1971, President Nixon imposed a 10% surcharge on imports and called on Europe and Japan to revalue their currencies.

- In the early 1980s, the yen did not rise significantly but in 1985, finance officers from major nations signed an agreement (The Plaza Accord)
affirming that the dollar was overvalued, and therefore, the Yen was undervalued → led to rapid rise in value of the yen.
- As such, with the yen off the linkage to the dollar after the collapse of the Bretton Woods System, it appreciated quickly, leading to complexities of trade.
- The appreciation of the yen affected Japanese exports as Japanese goods became more expensive abroad, hurting their export competitiveness. Consequently, Japanese exports abroad fell. As such, Japan, being highly dependent on its exports for economic growth, witnessed a decline in its economy as a result.
- Furthermore, in an effort for slowing exports, the government pumped new money into the economy through spending programs and lower interests rates → bout of inflation.

**Structural Problems**

**A) Rigidities of Big Conglomerates i.e. Keiretsu**

- More than 40% of companies’ shares are held by bank-related institutions, and members of the Keiretsu (business family) own 20 to 30% of the shares of their group’s bank. Hence, banks lend mainly to entrenched companies with which they have a relationship rather than funding up-and-coming ventures.
  - This is not a system favourable to new or small companies and it stymied industrial progress and innovation.
- In addition to the strong relationship between firms and banks, the Japanese economy is characterized by long term relationships between businesses in the form of keiretsu, or enterprise groups
- However, the Keiretsu system does not seem to have served Japan well in the 1990s. The current frontier of technological innovation touches industries and companies that are not traditionally affiliated with Keiretsu.
  - The horizontal keiretsu (across different industries) are typically composed of large companies in the finance and manufacturing sectors.
    ▪ However, it is not these established firms that are likely to experience the next wave of expansion, but service industries, such as transportation, discount retailing and entertainment.
  - For their part, vertical keiretsu (between a manufacturer and its suppliers) are not generally suited to the organizational needs of the service sector.
    ▪ In manufacturing, further efficiency gains will depend on initiatives of large discount stores and other retailers to
eliminate intermediaries or at least to reduce transportation costs and the profits margins of wholesalers, rather than on the keiretsu relationship.

B) Problems with the labour force
- Disappearance in labour surplus which had previously characterized the economy: By 1970, annual increase in population of working age had fallen to less than half of the middle 1950s. Reduction in former reserves of labour in rural areas.
  o Shortage of labour → pushed up wages → increased production costs → rise in price of intensive-labour goods → worsened inflation.
- The rise of an aging workforce was also a detriment to the Jap economy – percentage of employees older than 45 jumped from 34.8% in 1976 to 48% in 1997.
  o Why? Partly because of the long work hours that kept husbands away from home. Japanese women increasingly delayed marriages until their late 1920s and reluctant to have more than one child.
  o Significance: saddled Japanese firms with rising proportion of well-paid, less productive senior employees (drawback of the seniority wage system and lifetime employment)
- Growing shortage of unskilled and semi-skilled labour – many bankruptcies of smaller firms came about because of their inability to recruit such workers.

C) The seniority wage system and lifetime employment (the very strengths of the Japanese economy in the earlier period) now proved problematic as they incurred high costs.
- Job creation and destruction are normal – indeed, integral – parts of economic revitalization. For an economy, flexibility in hiring and firing is essential to recycle labour from less valuable to more valuable sectors.
  o Hence, the lifetime employment system which gave workers strong psychological attachment to firm, led to very low labour mobility between firms and industries which was very damaging to the economy.
- Despite its past advantages, there is mounting evidence that ‘lifetime employment practices are a reason why the Jap economy now faces long-term problems such as stagnant productivity growth rates and high costs.’ (Katz)
  o Japanese firms that are burdened with employees that they cannot layoff are facing costs that cause great disadvantage in international competition.
- Furthermore, to avoid massive layoffs, many companies initiated a policy of reducing salaries, wages, and bonuses to reduce the high costs of lifetime
unemployment, thus lowering the living standards of many employees and decreasing spending, which, in turn, has prolonged the economic decline.

- This is coupled with the seniority-based wage system which became an obstacle that chokes away companies’ growth potential
  - While encouraging loyalty and hard-work, the seniority wage system tends to discourage innovation and risk taking, the very qualities that are vitally needed in hi-tech and service industries.
    - Studies of promotion in Japanese companies illustrate that those who don’t fail at tasks tend to get promoted.
  - Kept labour costs down in 1950s and 60s but by late 1980s and 1990s, firms were top-heavy with these more expensive workers just as the nation plunged into prolonged recession
    - Backfiring of seniority wage system led to layoffs (to avoid workers collecting on their seniority) → led to increased unemployment (faster growth unemployment has been among men aged 45-54)

D) Deficiencies of government policy also contributed to the downfall of the Japanese economy as the policies that worked in the early period were not necessarily appropriate for the changed circumstances of later decades.

- Katz argues that the system that propelled Japan to economic success in the 1950s and 60s had soured – policies, priorities, regulations, institutions, protectionism – that generated economic miracle were appropriate for recovery and catch-up phase of development but proved less relevant and futile as the Jap economy matured.
- In mature economy of the 70s, government should have loosened “developmentalist” policies but instead they intensified them e.g. when oil crisis of 1973 and 1979 hurt basic industries, protectionist measures for these industries increased.
  - Excessive government regulation on businesses and financial institutions tended to weaken their sense of risk or discouraged risk-taking behavior, dulled the threat of competition, and delayed their adjustment to changes in the business environment, hence fostering inefficiencies that was detrimental to the economy.
  - Hence, this also made regulated industries more susceptible to damages caused by a weakening of the external economic environment.
- As a result, the aim of Japanese economic policies changed from “picking winners” (encouraging success in promising industries) to “protecting losers” (protecting sunset industries and postponing restructuring)
  - Overall thrust of Japan’s industrial policy switched from ‘acceleration’ to ‘preservationism’, undeniably slowing down economic growth.
Regulation also brings about a high-cost structure – leads to price differentials between Japanese and overseas markets.

- In 1998, aggregate consumer prices were 41% higher in Tokyo than in New York City.
- A high cost-structure imposes a cost burden on tradable sectors and weakens Japanese international competitiveness.
- Japan, being a highly export-dependent economy, suffers heavy damages as a result.

E) Iron Triangle (between big business, bureaucracy, LDP politicians) – a coalition of interest groups that worked together when common interests dictated) can claim credit for overseeing economic miracle but now considered responsible for the economic malaise.

- Politicians and mandarins who stand to lose most from deregulation slowing pace/scope of change reform → vested interests of the old paradigm skilfully defending their privileges
- Flaws of old system exposed dramatically → collusive, corrupt, and opaque practices intrinsic to this system have been identified as the culprits in what went wrong
  - Lack of accountability and transparency permitted incompetence and negligence on a grand scale
- Made institutional change hard – once companies and their labour forces have learnt to make money in a certain framework, they have a stake in keeping things as they are. Resistance to change meant greater inflexibility of the Jap economy which was an insurmountable obstacle in light of the economic depression that led to Japan’s economic malaise.

F) Rise of regional competitors/rivals e.g. Korea, Taiwan and Singapore

- Regional rivals/NICs (e.g. South Korea, Taiwan, Singapore) had edge on labour costs (relatively low in these countries), were quickly climbing technological ladder, closing the gap with Japan
- Rivals making inroads in worldwide steel, shipbuilding, black and white TV, automobile markets
- Double whammy of high oil prices and rising yen permanently priced some Japanese industries out of the market e.g. aluminium, petrochemicals

1980s: Bursting of the Bubble

Background

- Between 1986 and 1990, Japan experienced an economic bubble in which real estate and stock prices greatly inflated
Nikkei stock index hit its all-time high on December 29, 1989 which it reached an intra-day high of 38,957.44 before closing at 38,915.87.
- Additionally, banks granted increasingly risky loans -> property prices were highest in Tokyo’s Ginza district in 1989, with choice properties fetching over 100 million yen.
- Both stock and real estate prices plunged in 1990 and kept on heading down.
  o This is what is known as the ‘bursting of the bubble’ and had devastating im pacts on Japan’s economy, resulting in what is known as ‘the lost decade’
  o By 2004, prime “A” property in Tokyo’s financial districts had slumped to less than 1 percent of its peak.
  ▪ Tens of trillions of dollars worth were wiped out with the combined collapse of the Tokyo stock and real estate markets.
- The bubble and its bursting is the major cause of Japan’s economic problems in the 1990s.

Factors Leading To The Creation Of A Bubble Economy

A) Presence of excessive liquidity allowed surplus capital to be funneled into stocks and land, driving an appreciation in asset prices and wildly optimistic speculation
- Japan’s current account surplus and government restrictions on overseas investment by individuals and institutions during late 1980s created huge pool of excess money sloshing around Japan.
- Decision to allow steep appreciation of the yen in the Plaza Accords of 1985 also contributed to excess liquidity as it was accompanied by economic stimulus measures taken by the Bank of Japan and the government.
- Hence, in absence of alternative investment vehicles and with extremely low interests rates on bank deposits and government bonds, -> surplus capital was pumped into stocks and land, driving an appreciation in asset prices
- Price rise was further intensified by greed and herd mentality – powerful group psychology that encouraged people to suspend their judgement and worry more about being left out of the boom. Continuing escalation in prices of stocks and real estate became a matter of faith and investors remained confident even as prices plummeted that there was still untapped momentum if they remained invested and patient.

B) Government interest rate policy also contributed to speculation by making it very cheap to borrow money, injecting huge sums of money into system already awash with capital.
- The Japanese government was promoting expansion with cheap money -> managed to spur growth averaging 5% between 1986 and 1989 (at a time when other leading economies were languished in recession)
- Further worsened by the LACK OF SOUND CORPORATE GOVERNANCE.
  o With such low interest rates, bankers had to loan more money to turn a profit -> aggressively expanded lending without careful credit assessment.
  o Neither did banks nor the government monitor how the money was used
    ▪ Seemed like green light from bankers and governments for companies to borrow vast sums of money to engage in Zaitech (‘financial technology’ – asset speculation that boosted a company’s balance sheets)
- As a result, double trading – borrowing money for speculation – became a common practice
- Keiretsu banks also lent on basis of group solidarity rather than careful risk assessment
  o Hence firms could borrow at negative interest rates and without any effective market signals
  o Cost of capital for a while became effectively zero.
- Mismanagement of economic policies by the Finance Ministry bureaucrats – they failed to pursue policies that would effectively address the problems that had accumulated during the bubble era.
- In other words, with government running a loose monetary policy and bankers eager to lend money, risks were thought to be minimal and megaprojects were launched without consideration of worst-case scenarios or returns.

C) The role of the Yakuza
- Yakuza stand accused of manipulating bankers and bureaucrats to secure huge loans for speculative and illegal activities → many of the jusen (bank-related real estate lending institutions) had yakuza ties
- Caused many of the loan problems, suggesting that the bubble was a giant con game that enriched the mob at the public expense.

Reasons For The Bursting Of The Bubble/Collapse Of The Bubble Economy

A) Central Bank’s effort to control inflation burst the bubble
- The Bank of Japan’s recognition that a runaway economy could spawn higher inflation and its subsequent policy of raising interest rates five times
in 1989 to prevent asset inflation from spilling over into the rest of the economy burst the bubble
  o In late 1989, Yasushi Mieno, the bank’s new head, raised interest rates sharply.
  o Without easy credit, the speculative machine went into reverse, causing land prices, the stock market and corporate investment to slide, hence the economy slowed dramatically.
- In the Black August of 1990, the value of Japanese stock market fell by over 16% in a single month, a development precipitated by the Iraq invasion of Kuwait.
  o From then on, share and asset prices fell and many newly acquired overseas companies and assets were sold off by their Japanese holders.
- As a result, Japan was mired in recession during the 1990s

**IMPACT OF THE BUBBLE BURST**

**A) Prolonged recession in Japan and led to depressed business conditions**
- All economic indicators showed signs of this recession -> money supply, housing, durable goods, inventory, employment, machinery orders, capital expenditures.
  o E.g. as of late 1997, industrial production barely higher than in 1990
  o One million manufacturing jobs disappeared between 1992 and 1996
- Reduced domestic consumption

**B) Massive loan defaults and bankruptcy due to collapse of stock and land prices**
- The burst of the bubble which sent stock and land prices tumbling forced 10723 companies into bankruptcy owing a record $60 billion in debt.
  o When the bubble burst, the construction and real estate sectors failed to make a profit and quickly became unable to repay their debts.
  o With plunging real estate prices, the liquidation of real estate collateral proved insufficient to cover loans, hence non-performing loans quickly accumulated on a massive scale.
- Put significant pressure on bank-created keiretsu
- Unraveled business relationships and practices

**C) Banking crisis in 1997-98**
- Bursting of the bubble in the early 1990s made highly indebted firms unable to repay loans due to the decline in collateral values, thus creating non-performing loans (NPLs)
As a result, NPLs rapidly increased in the banking sector, and the banking system fell into a systemic crisis in 1997-98. Many banks went under, and those that survived only managed to do so through hundreds of billions of dollars of government bailout money. Though tax-payer funded bailouts restored some stability to the wobbly financial system, it was at the expense of public confidence in the credibility of the government leaders and bankers.

**D) Collapse of major financial institutions, signifying the end of the ‘convoy system’**
- Corporate profits stagnated, coupled with the accumulation of non-performing loans and the plunge in the market values of equities, major financial institutions e.g. Hokkaido Takushoku Bank, Yamaichi Securities went bankrupt in 1997. It was the first time in history of post-WWII development of the Jap economy.

**E) Bubble unleashed unprecedented criticism of Japan’s corporate culture and its values and as a result, corporate practices and structures began to change**
- Change in employment practices and abolishment of long-term employment practice: Unemployment rate rose from 1-2% in the early 1980s to 5% in 2000. Share of ‘non-regular’ employees such as part-time workers, fixed-term workers, and temp workers sent out by ‘temp agencies’, had drastically increased.
- Decline of the *Keiretsu*
- Government moved to ban activities of the *sokaiya* (corporate extortionists connected with the *Yakuza* gangsters).

**F) Persistent deflation**
- The Japanese economy experienced persistent deflation starting in the middle of the 1990s. This, too, was a phenomenon never before experienced in the post-war development of Japan.

**G) Detrimental social consequences**
- Families suffered rising divorce rate and children were yanked out of university because tuition had become an unaffordable expense
- 1999 – number of suicide hit an all-time high of 33,000 and 20% of these deaths are attributed to debts or job loss (nearly double the corresponding figure of 1998)
- Growing cardboard-box communities of homeless men gathered in train station areas