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The "Hidden" Side of the "Flying-Geese" Model of Catch- Up Growth: Japan's *Dirigiste* Institutional Setup and a Deepening Financial Morass

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ABSTRACT

Japan is in the eleventh year of stagnation with a prolonged financial malaise. Just a little over a decade ago, Japan's phenomenal growth was admired and even feared as a juggernaut. Japanese scholars and policymakers came to often describe Japan's industrial advance in terms of the so-called "flying-geese" model of catch-up growth, a sanguine expression that has also been played up in the media. Japan once did play the role of Asia's lead goose before the burst of the 1987-1990 asset bubble. The model is useful in capturing the essence of Japan's successful industrial upgrading and Asia's trade-led growth but fails to explain why such a success would ever lead to the present economic predicament. This is because it ignores the institutional, especially financial, underpinnings of Japan's catch-up strategy. What were the key enabling institutional features of Japan's once effective FG catch-up strategy? How did they function? Why did they come to cause the 1987-1990 bubble and the current financial imbroglio? How will Japan be "reformed"? All these developments and issues need to be examined as path-dependent evolutionary events within a reformulated "flying-geese" model, an "institutional" model of FG catch-up.

1. INTRODUCTION

Japan is in the economic doldrums and even in a potentially imploding financial crisis. It struggles to rebound from a decade of stagnation. However, Japan's phenomenal growth was once admired and even feared as a juggernaut. Japan and the rest of Asia grew in tandem and basked in clustered regional prosperity, which the World Bank (1993) called the "East Asian miracle." One popular way of describing such a regionally agglomerated growth was the model of so-called "flying-geese (FG)" formation. In this depiction, Japan served as Asia's lead goose, the NIEs as the second-ranking geese, and the ASEAN-4 as the third-ranking geese, and China as a new latecomer goose. Yet, Asia's seemingly orderly flight suddenly came to disarray, culminating in the financial crisis of 1997-98. Miracle was turned to debacle overnight.

Ever since the start of the 1990s Japan, a supposedly Asia's lead goose, has been mired in a self-inflicted financial crisis ever since the bubble of 1987-1990, which is now made all the more dangerous with a "triple deflation"—simultaneous declines in the prices of goods, real estate, and equity shares. The Japanese economy is in a vicious circle of "a drop in share prices->a decline in bank's asset value and land prices as collateral->a credit crunch->more business failures->a rise in bad loans->a further drop in share prices." Very recently (March 19, 2001), the Bank of Japan adopted a drastic monetary policy to flood the economy with liquidity. This policy is called "*ryoteki kanwa* [quantitative easing]," an unprecedented (some call "twilight-zone") monetary policy designed to prevent "price destruction" in hopes of stimulating demand.

This paper argues (i) that the conventional FG model of catch-up strategy, though instrumental in depicting the essence of latecomers' (notably Japan's) industrial upgrading and Asia's trade-led growth, has so far neglected the institutional (especially financial) dimension of such a catch-up, (ii) that Japan's present financial imbroglio is paradoxically the very outcome of its successful FG strategy that was once pursued under a special set of institutional arrangements after the Second World War—that is, the FG catch-up regime became soon obsolete and even rigidified over years, trapping Japan in the present financial quagmire, and (iii) so far, the reform is, strangely enough, "market driven" in the sense that two key market imperatives---inward mergers and acquisitions (M&As) by foreign investors and the mandate of the Net-driven New Economy--have begun to compel Japan to remold itself more compatible with the norms of global capitalism.

In other words, this paper emphasizes those causes of Japan's current predicaments that are not adequately examined from an institutionalist point of view. Japan is not in a real-sector crisis; its fundamentals (technological and productive capabilities and wealth accumulation, though there is definitely a hangover of excess capacity) are as strong as ever. It is in an institutional crisis. There are good reasons why reforms are so hesitantly implemented--that is, not so swiftly and so decisively as outside pundits think Japan

should do, particularly when they apply the logic of Anglo-American market-based tenets.¹

2. “FLYING-GEESE” CATCH-UP STRATEGY

The FG model of economic development was originally introduced by Kaname Akamatsu, a well-known Japanese economist, in the 1930s (*inter alia*, Akamatsu 1935) and has been expanded by his followers, notably Kojima (1958, 1960, 2000), Shinohara (1972), Yamazawa (1990), Kojima and Ozawa (1984, 1985), and Ozawa (1993, 1996, 2000a). Akamatsu was among the very first to recognize the economic significance of what he identified as “the alignment from advanced nations to backward nations according to their stages of growth.” He argued that “It is impossible to study the economic growth of the developing countries in modern times without considering the *mutual interactions* between these economies and those of the advanced countries” (Akamatsu 1962). He did not, however, leave any formalized model to explain his ideas. The FG analogy came from his empirical findings of the “import->domestic production->export” pattern of sequential growth in some prewar Japanese industries (such as textiles) which traced out a wave-like pattern of each activity in the sequence similar to a flying-geese formation. In essence, however, what he had in mind was an *evolutionary model of sequential catch-up through teacher-learner relations among the nations along the stages of industrial upgrading*. It was a model of *derived* economic development in a latecomer nation.

In fact, the world history of economic development is nothing but a repeated history of industrial leadership and subsequent emulations. Ever since the Industrial Revolution in England, industrialization in the rest of the world wherever successful has been essentially a derived phenomenon, in the sense that a follower or learner economy can emulate and learn from the already advanced (leader or teacher) economies. Continental Europe industrialized by following Britain through commercial contacts and conscious efforts for learning and emulation (Landes 1969). So did the United States; as Lester Thurow (1985) bluntly put it, “America started off as a copier” and “stole British technology.” Of course, America certainly added numerous innovations and improvements, particularly in the area of mass production and marketing. So did Russia in its modernization efforts (Gerschenkron, 1962). And likewise, Japan’s economic miracle in both the pre- and post-Second-World-War periods was based on this mechanism of learning and emulation under the hegemony of Pax Britannia early on and

¹ For example, *The Economist* (“The danger of delay,” March 31, 2001: 17) had the following to say: “Banks have made slow progress in writing off bad loans, and companies have been equally slow to sell off assets and reduce debts. Unviable firms have *foolishly* been kept alive with bailouts, rather than being broken up or allowed to go bust. Governments have also *failed* to deregulate services, which would help to spur domestic demand” (emphases added). Why is corporate Japan so “foolish”? And why has the government so far “failed” to deregulate services?

under that of Pax Americana more recently. Both hegemonies created a concatenation of leader-follower links among the nations.

Thus, Japan's sequence of industrial transformation is basically the same one trekked by the advanced West over a much longer period of time (over a century). But Japan was able to accomplish catch-up industrialization in a *time-compressed* fashion as a latecomer by learning from the West. This time compression of industrial upgrading is accelerating for a variety of reasons. The NIEs have done more quickly than Japan; so will China than the NIEs and ASEAN-4.

The catch-up regime Japan set up after the Second World War was, however, rather a nationalistic (self-centered) *dirigiste* one which stressed an "infant industry" protection for domestic industries with restrictions on inward foreign direct investment (FDI). This *dirigiste* development approach was the essence of Japan's FG catch-up strategy.

Three critical types of industrial policy were pursued under the FG strategy::

- (i) a policy for industrial upgrading from low value-added (low-productivity) to higher value-added (higher productivity) industries,
- (ii) a policy for import-substitution-cum-export-promotion (ISEP)--that is, to replace imports with domestic output and later to promote exports, and
- (iii) a policy to transfer comparatively disadvantaged industries or industrial segments onto other countries (mostly nearby developing Asian countries) so as to retain higher value-added industries at home, a process that may be identified as "comparative advantage recycling (CAR) and resource reallocation at home."

Obviously, the outcomes of these policies were closely and sequentially interrelated. Industrial upgrading policy is the ultimate goal of the FG strategy. And it can be accomplished by the ISEP sequence and the CAD mechanism. Once a new comparative advantage (commensurable with Japan's prevailing/newly altered factor endowments and technological conditions at a given point in time) was created out of formerly disadvantaged industries through the ISEP policy, Japan continued to foster other future growth industries at home—that is, to move up the ladder of industrial upgrading. And once export industries (or industrial segments) began to lose competitiveness (i.e., now become comparatively disadvantaged), they were transplanted via overseas investment onto other countries, especially the developing Asian countries where the factor endowments and technological conditions are still suitable for such industries. What is more, those goods transferred and produced overseas are now imported back to home—hence, the ISEP policy eventually turns to the sequence of "import->domestic production->export->overseas production via FDI/licensing->import."

The interface between industrial upgrading at home and CAR via multinational corporations (MNCs) can be best described in terms of the "industrial restructuring" model of FDI (Ozawa 1992), which is actually a reformulated FG industrial policy (ii) above explained, with emphasis on the role of cross-border investment as a facilitator of structural change, Japan's industrial structure has gone through continuous metamorphic

changes, a process that can be chronologically divided into four sequential stages of transformation (**Figure 1**):

- Phase I. Expansion of labor-intensive manufacturing in textiles, sundries, and other light industry goods as the leading export sector (1950 to the mid-1960s).
- Phase II. Scale-economies-based modernization of heavy and chemical industries such as steel, petrochemicals, and synthetic fibers as the leading growth sector (the late 1950s to the early 1970s).
- Phase III. Assembly-based, subcontracting-dependent, mass production of consumer durables, such as automobiles and early-generation electric/electronics goods (TVs, VCRs) as the dominant sector (the late 1960s to the present).
- Phase IV. Mechatronics-based, computer-aided flexible (or lean) manufacturing of highly differentiated multi-variety goods, along with R&D-driven breakthroughs such as HDTVs and other latest-generation electronics, new materials, fine chemicals, and more advanced microchips (the early 1980s onwards).

The transition from one phase to another has certainly not been clear-cut but has overlapped in the above chronological approximations. On the theoretical plane, the leading sector in the first phase may be identified as the “Heckscher-Ohlin industries,” the second phase the “non-differentiated Smithian industries,” the third the “differentiated Smithian industries,” and the fourth the “Schumpeterian industries.” The model is basically a “leading growth sector” model *a la* Schumpeter, in which a sequence of growth is punctuated by stages in each of which a certain industrial sector can be identified as the main engine for structural transformation. This model is basically a leading-growth-sector model *a la* Schumpeter (1935). It is in sharp contrast to the neoclassical view of growth as a smooth incremental accumulation of capital.²

² This point is emphasized by Rostow (1960: 6): “In essence it is the fact that sectors tend to have a rapid-growth-phase, early in their life, that makes it possible and useful to regard economic history *as a sequence of stages rather than merely as a continuum, within which nature never makes a jump* (emphases added).”

It should be noted that the above stage model of industrial upgrading is not a mere typology of stages of growth and that stage-to-stage progression is certainly not automatic but requires some enabling forces. These forces are composed of (i) the self-restructuring/reorganizing (rational) mechanism of the market in both supply and demand conditions, (ii) the strategic innovative behaviors of individual business firms, (iii) the influences of culture and traditions, and (iii) government policies. This set of forces facilitated swift structural upgrading. But it was initially the Japanese government’s industrial policies that capitalized on the forces of the market and cultural influences so as to realize rapid industrial changes, especially during the second stage of catch-up, namely the scale-driven “nondifferentiated Smithian” stage of heavy and chemical industrialization (Ozawa 1995, 1979, 2000a). The second enabling force, namely the strategic innovative behaviors of individual business firms, becomes increasingly important as the stage of industrialization advances. The birth of the Toyota production system is a good example. Here I owe to Dieter Ernst for making me to pay more attention to the role of individual firms’ strategies and operations in facilitating a process of industrial upgrading via innovations. See Ernst (2000a, 2000b).

Japan has so far fully completed the first three phases of industrial metamorphosis and is currently in the midst of its fourth stage. And interestingly enough, Japan's overseas investment has exhibited similarly varied patterns, so far four major distinct patterns in a sequential manner, each reflecting the nature of its corresponding era of industrial activity at home. This stages-specific correspondence between structural transformation and FDI is schematically illustrated in Figure 2. The revealed phases of FDI can be identified as (1) the elementary stage of offshore production (or low-wage-seeking investment), (2) resource-seeking and house-cleaning investment, (3) assembly-transplanting investment, and (4) alliance-seeking (strategically networking) investment. **(See Figure 1)**

The ISEP policy in particular required heavy involvement of government in protection, technology imports and infrastructural development, industrial finance and export promotion, especially for modernization of pre-war built heavy and chemical industries. As will be explored below, Japan's *keiretsu* system was promoted and utilized as part and parcel of industrial policy. And in this trade-focused strategy of development of a specific good or industry, inward FDI was restricted and critical technology was acquired in an "unpacked" manner, that is, mostly under licenses. Later on, the sequence shifted to that of basic technology import->commercialization at home (i.e., domestic production)->export (TICE), as best seen in many of Japanese innovations such as transistor radios, pocket-size calculators, quartz watches, etc. In this later version, government role declined, while adaptive corporate R&D and entrepreneurship played a crucial role in innovation.

For the purpose of our analysis, it is important to stress that Japan enjoyed a high-growth period when it went through both the labor-driven "Heckshere-Ohlin" stage and the scale-based "nondifferentiated Smithian" stage during the 1950s, the 1960s, and the early 1970. Such high growth can be most appropriately called "input-driven" *a la* Krugman (1994), where an abundance of labor is mobilized mostly from the rural areas and combined with capital to produce a rapid rise in productivity—hence domestic output, although the Japanese experience was also accompanied by a rapid rise in efficiency itself³

Seen in this light, Japan's industrial rise has been almost flawless. Thanks to the FG strategy of catch-up (i.e., *acquire advanced industrial knowledge as much and as quickly as possible from the West through emulation*), its technological level and productive capability are now overall on a par with the United States and the EU. It has a huge reservoir of private wealth, and is a formidable competitor in the world economy. There is nothing wrong with its "fundamentals." But its economy is in a financial shambles, and even considered a drag on the rest of the world. What went wrong with the FG

³ . This can also be viewed in terms of a Cobb-Douglas production function $Q = AL^\alpha K^\beta$. A (total factor productivity) rose mostly because of technological borrowing from overseas, L (labor) expanded due to mobilization from the rural sector, while K (capital) increased for the reasons explained below. And during the period of heavy and chemical industrialization $\alpha + \beta$ became greater and greater than one, reflecting scale economies or increasing returns.

strategy? In order to explain why the FG industrial upgrading succeeded in Japan--and why it has later ended up with a financial debacle, we must first understand its *dirigiste* catch-up regime.

3. JAPAN'S INSTITUTIONAL MATRIX FOR FG CATCH-UP

What is missing from the rosy picture of Japan's growth as depicted in the above FG model of catch-up is its much neglected institutional dimension. Each economy has its own set of institutions for economic activities, and its overall economic performance is largely determined (enhanced or retarded) by such an institutional arrangement (North 1990). Such a set can also be called "an institutional matrix that defines the incentive structure of society" against the backdrop of "the belief system" that connect "reality" to the institutions (North 1999: 9). Japan arranged a catch-up regime suitable for its own prevailing socio-economic conditions in the early postwar period by combining formal rules with traditional norms and mores or "Asian values."

Japan's FG catch-up regime was effective mostly during the high-growth stage of heavy and chemical industrialization (up until the mid-1970s). It was based on, and supported by, four key elements: (i) state-directed bank-based finance (the "main bank system" and the "stakeholder model" of corporate governance), (ii) *Keiretsu* formation, (iii) the "privatized welfare/pork-barrel" sector, and (iv) the principle of "job primacy over efficiency" as an implicit social contract. As will be explored below, *these elements have evolved and converged in a sequential and path-dependent fashion to cause some critical institutional misalignments (incongruities) which culminated in the recent and current economic crises as the vicissitudes of Japan's once phenomenal catch-up growth, FG-style. The institutional misalignments have been caused by the combined forces of the fast-changing market conditions that Japan's dirigiste catch-up regime itself created and the rigidification of such a regime which was set up in the early postwar period.* All the path-dependent evolutionary developments that have transpired are sketched out in Figure 2. (See Figure 2)

3.1. State-directed bank-based finance and repressed capital markets

As is typically the case with any developing countries, Japan once resorted to and maximized the use of bank-based finance for catch-up growth instead of capital-market-based finance. In this scheme, Japan also used "central-bank-based finance" (the Bank of Japan created funds internally) rather than "CA-deficit-based finance" (i.e., borrowings from overseas) (Ozawa 1999, 2001). These two, but especially the latter, are the crucial financial aspects of catch-up growth which the FG model has not so far taken into account, but which can shed light on the puzzle of a successful FG catch-up process suddenly winding up in a crisis.

At the start of postwar growth the stock market initially did play as a source of funds for corporate investment in Japan. Yet, the stock market (especially the Tokyo Stock Exchange or TSE) was meant only for large well-established corporations and not for startups (even if promising), which were badly in need of new capital. The latter had to

show profits for at least three consecutive years to be qualified for stock listing (hence no chance for any promising startups to be listed). Furthermore, even if qualified, they had to climb up the hierarchy of the stock markets, starting first with one of the country's eight local bourses, the over-the-counter market, or on the TSE's second section—and finally, under rigorous screening, on the TSE's first section, a time-consuming journey taking as long as 20 years.⁴

Soon, however, bank loans were purposefully promoted for corporate finance as the essential financial strategy of overall FG industrial development policy, and equity finance quickly became secondary to bank loans. In order to control credit expansion, moreover, the government prohibited corporations from issuing bonds. A bond-issuing privilege was granted only to those financial institutions (mainly, three long-term credit banks and utilities) that were specifically designed to finance public purpose long-term projects. Consequently, there was early on no choice on the part of corporations but to borrow from banks.

Dependence on bank loan thus became the critical mechanism through which a policy of financial repression was implemented by keeping interest rates low, controlling market competition (via entry regulations), and channeling capital to policy-targeted sectors and projects. Under close supervision and control of the Bank of Japan, which was virtually a policy arm of the Ministry of Finance, the six major *keiretsu* banks (Mitsui, Mitsubishi, Sumitomo, Fuji, Sanwa, and DKB) played the role of “main banks” for their respective groups in investing in heavy and chemical industries the capital injected by the central bank. Bank-created money did not lead to any serious inflation, since (i) the funds were carefully invested in supply-increasing industrial projects and (ii) the monetary spigot was turned off as soon as Japan encountered a balance-of-payments deficit, a deficit caused by such an expansionary monetary policy (Wallich and Wallich, 1976). That central-bank-augmented credit creation for growth was a *classic case of development finance in the early-stage of industrial capitalism* as envisaged and theorized by Schumpeter (1934), who even called the banks as “the headquarters of the capitalist system.”⁵

Capital markets were given a supplementary role, and the bond market in particular was even discouraged to develop until the mid-1980s; corporate issues and the development of a secondary market were severely discouraged (Patrick, 1994). That state-augmented banking system naturally produced a “moral hazard” effect, since high-risk investments were encouraged and the central bank always stood ready to bail out any *keiretsu* bank at the first sign of financial difficulty; they were *strategically too significant to fail*. Small and even inefficient banks were equally protected under the scheme popularly referred to as a “convoy system,” in which strong banks were obliged

⁴ Because of this rigidly regulated system of stock listing, the TSE itself is now stuck with old Japanese companies, many of which are now in dead-end industries and whose stocks are no longer so actively traded. This predicament is well described in “time for this behemoth to evolve?” *Business Week*, September 20, 1999: 48.

⁵ It should be noted that Schumpeter recognized the role of securities (equity shares and bonds) in finance but that he considered them basically by-products or derivatives of the very process of development that would be brought about by bank loans in the first place (Ozawa 1999).

to guard weak ones. The result was that banks' operations became extremely asset-expansive as they eagerly extended loans—especially in the context of inter-*keiretsu* oligopolistic rivalry as the *keiretsu* competed vigorously with each other in setting up a similar set of industries, a phenomenon that came to be called the “one-set” principle (Miyazaki 1980).

Banks—and their *keiretsu* customers—were thus all the more willing to take risks because they could count on government help. Moral hazard was actually needed as an inducement to promote large-scale investments in capital-intensive, scale-driven industries, since these industries imposed high financial risks on the private sector. Without government support and the *keiretsu* formation, individual enterprises alone might have been reluctant to plunge into new large-scale ventures during Japan's heavy and chemical industrialization (from the mid-1950s to the early 1970s). A rise in national output capacity (aggregate supply) had to be induced to match the liquidity (aggregate demand) pumped into the economy by the central-bank-augmented credit creation in order to prevent inflation (as emphasized by Schumpeter). This type of moral hazard, then, can be identified as the *socially justifiable* type, since it induced socially desirable investments in the modern sector, thereby facilitating a swift industrial transformation.

Ironically, the very success of *dirigiste* bank-based capitalism, however, came to undermine the privileged position of banks. It was a self-destructive system. Thanks to the low-cost capital made available under such a system, big corporations, mostly in the *keiretsu*, grew quickly and accumulated internal reserves. That accumulation itself was made possible because companies did not need to pay out much dividends (post-tax payments) and paid mainly a fixed amount of interest (pre-tax payments) without regards to profitability. This setup left greater retained earnings. The rapid expansion of internal reserves served as an emancipator from dependence on banks. In other words, the main bank system itself was responsible for making the banks' clients less and less dependent on loans—hence less susceptible to monitoring and more autonomous in investment decisions (Ozawa 2000c).

Moreover, as Japan entered the subsequent phase of assembly-based, components-intensive industries, notably automobiles and electronics, leaving behind heavy and chemical industries, there soon emerged new world-class manufacturers. Many of these manufacturers actually did not originate as *Keiretsu* firms which were supposedly best coached by their main banks. These new companies started out as outsiders (non-*keiretsu* upstarts) in the postwar period and have largely remain as such ever since. They were also those maverick companies that began actively to issue new stocks at market prices, thereby breaking the custom of par-value issues.

A prime example is Toyota Motor Corporation, now the world's most efficient car maker, which has had no affiliation either with any *zaibatsu* (in the prewar days since its establishment in 1937) or any major *keiretsu* (in the postwar period). In fact, the company has persistently avoided external debts. Its internal reserves became enormous, so much so that Toyota itself came to be known as the “Toyota Bank.”

Honda is another example, which in its infancy had a hard time securing bank loans because of its initial status as an independent upstart. It originated as a bike repair shop in the early postwar period. Only later on, the company became “affiliated” with the Mitsubishi Bank (now Tokyo-Mitsubishi Bank). Likewise, Matsushita Electric Industries quickly accumulated huge internal funds and has ever since been practically free from external debt.⁶ It is also often called the “Matsushita Bank.” Sony was also no exception as a non-*keiretsu* firm.

Furthermore, some successful Japanese corporations were soon able to tap the international capital markets for their financing needs at low costs as restrictions on borrowings from abroad were lifted with the amendment of the Foreign Exchange Control Law in 1980.⁷

As the result of ever-increasing internal funds and the opportunities to raise capital abroad, there was thus no reason for them to be subservient to their banks and to be dictated about how to run their own businesses by bank officials. Besides, the main bank system might not have been as beneficial for the affiliated firms as described by its proponents, who emphasize the magic of the system in solving the problems of information asymmetry and transaction costs. Over the 1983-87 period (that is, at the height of assembly-based “differentiated Smithian” manufacturing), retained earnings accounted for as much as 53 percent of the sources of funds in Japan.⁸ One empirical study (Weinstein and Yafeh 1998) reveals (i) that the cost of capital of bank-affiliated firms was higher than that of their peers (nonbank-affiliated ones) and (ii) that most the benefits from relation banking were appropriated by the banks. No wonder, then, the “departure from banks” syndrome intensified. Japan’s main bank system was effective in capital allocation only during the early stages of Japan’s postwar FG catch-up growth--at most until the early 1980s with 1975 as its watershed year.

It was against the background of this rapid structural change in the market that a bubble economy (1987-1990), stemming from, and fed by, speculative investments in real estate and stocks, occurred. Because of the easy monetary policy adopted to combat the so-called “high-yen” recession after the Group-Five (G5) Plaza accord in 1985, the banks became awash in liquidity. They found small- and medium-sized enterprises, real estate firms, distributors (both wholesalers and retailers), and construction companies as their new major borrowers. The share of this group of borrowers soon accounted for as much as one third of total bank loans. Real estate firms alone were responsible for one

⁶ “In 1984, Matsushita... paid out less than ten percent of its earnings in dividends, retaining the balance of reinvestment. As one consequence, Matsushita has been growing in sales nearly 15 percent a year and doing so without incurring the risks and costs of bank borrowings” (Abegglen and Stalk 1985: 187).

⁷ “As a fraction of all securities issued by Japanese companies, overseas issues [reached] nearly 50 percent by 1985” (Kester 1991: 188). As far as bonds are concerned, “within three years of the revision of the Law, the value of bonds issued abroad exceeded the value of bonds issued domestically” (Weinstein and Yafeh 1998: 637).

⁸ As cited in Baums (1994).. He also pointed out that this Japanese percent compared with 72 percent of the sources of funds in Germany, and 66 percent in United Kingdom over the same period.

quarter of the total. In addition, the banks channeled loans through non-bank banks (e.g., housing-loan companies and consumer credit firms), since the latter were less strictly regulated than the banks themselves. These non-bank bank loans accounted for as much as 37.8 percent of the total loans the real estate industry secured (Noguchi 1992).

Low interest rates and the abundance of liquidity fueled the rising prices of stocks and real estate. With the soaring share prices and property values, firms and individuals borrowed even more since they used their assets as collateral. Thus a speculative spiral was set in. The *dirigiste* bank-based finance brought about the problem of moral hazard, but this time the moral hazard effect was thus of the *degenerative* type (in contrast to the earlier *socially justifiable* one).

The bursting of the bubble suddenly occurred in late 1989, following the rise in the discount rate. The debacle was a disaster for borrowers in real estate, construction, distribution, and finance, as well as for banks as lenders. The latter thus came to be saddled with the ever-rising amounts of bad loans, the very initial cause of Japan's present banking crisis.⁹

3.2. *Keiretsu formation, cross-shareholdings and aftermath*

The main bank system was organized with *keiretsu* formation, which emphasized collective collaboration not only within each *keiretsu* but also between the *keiretsu* and the government in industrial development. *Keiretsu* was part and parcel of Japan's industrial *dirigisme*, serving as the critical vehicle through which state-created capital was channeled into investment projects considered essential under industrial policies. *Keiretsu* served as an effective mechanism to reduce "coordination failures" in large-scale investment projects, which business firms *individually* are not willing or able to take risks. Only a collective investment can realize the potential of *increasing returns, linkages and complementarities* (dynamic external economies and indivisibilities) simultaneously in both supply and demand capabilities and spillovers.¹⁰

Another feature of the main-bank-cum-*keiretsu* system is *cross-shareholdings* among affiliated banks and firms. Mutual holdings of shares were practiced as a way of cementing the business ties among intra-*keiretsu* organizations and reducing transaction costs (especially the costs of the principal-agent problem and opportunism). The main

⁹ According to the latest tally of bad loans by the Japanese government, they stand somewhere between \$337.9 billion ("nonperforming loans" only) and \$1.23 trillion (at 122.52 yen = \$1) (including "problem loans"), thus all depending on how "bad loans" are defined. As reported in "Debate persists on size of loan problem in Japan, clouding Tokyo's ability to act," *Wall Street Journal*, April 24, 2001, p. C1.

¹⁰ . This is a classical case of market failure once debated when the notions of the "big push" (Rosenstein-Rodan 1955) and the "balanced growth" (Nurkse 1953) were advanced as a strategy for industrialization in the early postwar period. Hirschman (1958) also stressed the criticality of linkages in the process of economic development. While the big push approach applies to the economywide development, Hirschman's concept of linkages is relevant for complementarity among industries (Meier 1995), the phenomenon that *keiretsu* was concerned with. And the *socially justifiable* type of moral hazard discussed earlier is critically built on these linkage economies.

bank owns shares of its affiliated corporations and other affiliated (usually smaller) banks (up to the legal limit of 5 percent), and vice versa (no limit for non-financial firms, so long as they own other non-financial firms). The bank's holdings of stocks are said to serve as an important means of influencing the course of business in their client firms, while inter-corporate stockholdings in the non-banking sector is also a symbol of mutual trust (and hostage exchange) and long-term relations. In fact, the interlocking of stock ownership and directorship is what characterizes the *keiretsu* system, both of the financial (*kinyu*) and industrial (*sangyo*) types. It is expected to serve as a mutual monitoring mechanism which reduces transaction costs (the costs of the principal-agent problem, information asymmetry and opportunistic behavior). 10 to 25 percent of each constituent firm's stock has come to be held by other firms in the group. In addition, interlocked directorships occur in two-thirds of these firms; in other words, they have full-time executives dispatched from affiliated firms. "With access to senior management and confidential data, these related company shareholders are better prepared to monitor and influence corporate decisions than a fragmented group of public stock owners' (Jacobs 1991: 68).

The growth of cross-shareholdings is clearly seen in the changing distribution of Japanese stocks by holder (Figure 3). In 1950, for example, individual investors owned a little over 60 percent of total value of stocks, financial institutions (mainly banks and insurance companies) had about 12 percent and corporations 11 percent. But about 40 years later (in the latter half of the 1980s during the height of the 1987-90 asset bubble), individual investors' share declined to 24 percent, but financial institutions' and corporations' share rose to more than 40 percent and 28 percent, respectively (that is cross-shareholdings came to account for nearly two-thirds of the total). Investment trusts (the Japanese equivalent of mutual funds), foreign investors and pension funds owned relatively small portions, all less than 10 percent at any point in time over the 1950-94 period. In short, the intercorporate holdings of stocks by banks and corporations became a quite dominant feature of the Japanese ownership of stocks. It is against this unique background that cross-shareholdings and *keiretsu* formation have begun to unravel in the recent past, aggravating downward pressure on share prices as a large number of shares is "dumped" to the stock market (See **Figure 3**)

The *dirigiste* main bank system and the *keiretsu* formation (combined with Japanese-style labor relations to be discussed below) also caused, especially in the aftermath of the bubble burst, (i) the overcapacity, overdiversification and overstaffing of productive facilities in the non-financial (especially manufacturing) sector (with too many unprofitable subsidiaries and too many employees to be profitable), and (ii) the excessive number of banks (too many banks to be profitable). The former is contributing to the current deflationary pressure, and the latter aggravating the unprofitable (as yet fully restructured) banking sector. Thus the needs for business and financial restructuring have arisen out of Japan's once phenomenal growth.

It should also be mentioned in passing that the stock market in Japan was once often "tampered" by the government. The Investment and Loan Bureau of the Ministry of Finance had intervened in the stock market to "stabilize" (i.e., manipulate) share prices

by using the funds collected through the postal savings system. Until the mid-1980s, for example, the share prices of major Japanese banks remained nearly constant for long periods of time, since regulators wanted “to limit stock price fluctuations in an effort to influence the public’s perception of risk at banks” (Genay, 1999).

Because of a high level of insider control (almost two-thirds of shares are trapped in the web of crisscross holdings, as seen above), common equity investors had no power. Besides, stockholders’ annual meetings were usually held all on the same day so that investors with diversified portfolios could not attend all the meetings. To make matters worse, so-called *sokaiya* (literally, “general meetings experts”), who “expedite” proceedings by unsavory means, were hired to suppress any embarrassing questions from common stockholders. The *sokaiya* had close ties with *yakuza*, Japan’s organized crime. In the 1990s, several corporate executives of large well-known Japanese corporations (including Japan Airlines, Normura Securities and Dai-Ichi Kangyo Bank) were arrested or forced to resign because of their involvement with the *sokaiya* and organized crime.¹¹

Moreover, in the securities brokerage industry, the so-called *tobachi* (literally, “flying”) practice—under which brokerage firms’ prime customers were guaranteed for profits—was rampant. In fact, this illegal practice finally cost Yamaichi Securities, Japan’s oldest and fourth largest, its demise after a century’s existence in November 1997.

The Japanese system was a clear case of “insider control,” not only in the benign sense that the majority bloc of the capital stock is held by “friendly” affiliated banks and companies, but also and more importantly, because the government controlled the whole financial sector in such a way to encourage the use of stocks not as investment instruments *per se* but as a tool to support the main bank system through cross-shareholdings. Many politicians and big businesses profited from the rigged stock markets at the cost of small investors. It was the Japanese version of “crony capitalism.” The macro-financial “insider control” scheme thus has turned out to be a breeding ground for corruption—and the subsequent disastrous banking mess that had to be cleaned up with the use of hundreds of billion dollars of tax-payers’ money. No wonder politicians are held in low esteem, and a leaderless Japan is adrift (left to muddle through).

3.3. The inner-dependent industries as a politically protected (pork-barrel) sector

3.3.1. Emergence of structural dualism and the “Japanese disease”

As seen earlier in connection with the FG paradigm, Japan has been successful in nurturing dynamic comparative advantages and climbing up the ladder of industrial upgrading under the Japanese-style infant-industry strategy. It has been able to transform initially disadvantaged industries into competitive (and comparatively advantaged) ones. In the meantime, however, Japan also has had many once heavily regulated and protected industries, protected from competition both domestic and foreign, but especially from the latter, if not by outright tariffs, quotas and bans on inward FDI, then by regulations and

¹¹ These and many more scandals which came to light in the early 1990s are well documented and discussed in Tabb (1995).

red tape. The upshot is that a new industrial dualism has emerged: a highly multinationalized (initially only outwardly) efficient sector and a secluded import-averse, inward FDI-restrictive sector (Ozawa 1996). (See **Figure 4**)

The former may be called the *outer-focused* (OF) sector and the latter the *inner dependent* (ID) sector. The OF sector was best represented by automobiles and electronics, while the ID sector included the erstwhile sheltered “inefficient” primary industries (e.g., agriculture and fisheries) and services industries (such as telecommunications, transportation, wholesaling and retailing, construction, finance, insurance, and maintenance services --e.g., auto repair), as well as some manufacturing industries that are heavily domestic-market focused (e.g., food and beverage). In the beginning, extensive protection and a web of regulations were applied to the entire economy. In general, the OF sector was under the purview of the Ministry of International Trade and Industry (MITI), while the ID sector was under the supervision of a variety of inward-looking ministries: the Ministry of Agriculture, Forestry and Fisheries, the Ministry of Posts and Telecommunications, the Ministry of Transportation, the Ministry of Construction, the Ministry of Finance, the Ministry of Internal Affairs, the Ministry of Health and Welfare, and the Ministry of Labor, although some of them also had overlapping regulatory power over the OF sector in varying degrees and forms.¹² (It should be noted that in 2000 the Japanese ministerial structure was reorganized and all the ministries and agencies were renamed—supposedly representing government reforms. For example, MITI is now the Ministry of Economy, Trade and Industry or METI.)

These government ministries have been the home of the interventionists promoting the development of domestic industries under their jurisdictions, thus continuing the bureaucratic tradition established by the Japanese government after the Meiji Restoration of 1868. As a latecomer nation, government ministries and agencies were created, as Johnson (1989) so aptly observed, not so much as “civil servants” per se, as in the United States, but rather as “task-oriented mobilization and development agencies” whose main functions were originally “to guide Japan’s rapid forced development in order to forestall incipient colonization by Western imperialists.” That is to say, their current predispositions toward controls are path dependent—and justified from a nationalistic point of view.

The OF sector began to emerge as Japan pursued a FG-style strategy of dynamic “infant industry” protection. It took the sequence of “imports→domestic production→exports.” For example, to modernize the heavy machinery sector (such as electric turbine and generator) which Japan had already built in the prewar days, the motto was “the first machine imported, the second machine locally produced under

¹² Although MITI has often been perceived by outsiders as a staunch protectionist guarding Japan’s manufacturing sector, it was the first ministry to become “internationalist” or “globalist”—by Japan’s past standard if not by international standards—simply because of the need of most Japanese manufacturers to go overseas as multinationals. MITI has become much more internationally minded than, say, the Ministry of Finance and the Ministry of Posts and Telecommunications, not to speak of the Ministry of Agriculture, Forestry and Fisheries, and the Ministry of Labor.

licenses.” What made Japan’s infant industry protection work was the text of exporting; import-substituting domestic production was ultimately aimed at export markets, forcing the industry to improve on not only prices but also quality, eventually enabling it to leap scale economies (dynamic increasing returns). Japan’s automobile industry, which initially had to come up with “less scale-dependent/scaled-down technologies,” is the best example; the early-on protection of a small domestic market and a large number (more than ten) of domestic automobile producers who vigorously competed in entering this growth industry, as depicted by the “reserved competition” formula (Ozawa 1997), created a conducive/compelling environment for the birth of a so-called “lean or flexible production” originally at the hands of Toyota Motor Corp. (Ohno 1978; Womack, Jones, and Roos, 1990).

As dynamic comparative advantages were acquired in the OF sector, its rising trade surplus began to cause a sharp appreciation of the yen and an ever-rising competitive pressure on the ID sector. Hence this intersectoral effect via the foreign exchange market is the Japanese version of the “Dutch disease.” Imports should have become available to Japanese consumers at cheaper and cheaper prices in yen terms, but they were either hindered by trade barriers or they were not delivered/passed through at cheaper retail prices (i.e., the exchange gains were simply pocketed by the highly regulated/protected distribution sector). In fact, instead of having competitive forces rationalize the ID sector, the government used to hold on to—and even reinforced through administrative guidance—its regulatory involvement to further shelter the ID sector. The reason was that the ID sector as a whole (but especially finance, construction and distribution) was the key political power base (and financial source) of the Liberal Democratic Party, Japan’s long-lasting political party since the early postwar period. This is the reason why the ID sector may be most appropriately called a “pork-barrel sector.”

This aggravated all the more severely the structural gap between the two sectors in respect to their openness to the outside world and productivity, a gap which continued to be reflected in price discrepancies between home and foreign markets at the retail level. To cope with the ever-rising yen, the OF sector had to keep raising productivity to remain export competitive. As the sector succeeded in this endeavor, however, it again faced another round of yen appreciation because the ID sector did not absorb imports sufficiently enough to relieve the upward pressure on the currency. In other words, the OF sector came to be entrapped in a treadmill: a “vicious” circle from a struggle for productivity improvement and a greater trade surplus, to a higher-value yen, and to an even greater need for cost cutting (Ozawa 1996). Thus the Japanese version of the “Dutch disease” became even more *complicated* and *aggravated* because of interactive feedbacks between the two sectors—and needs to be identified *sui generis* as the “Japanese disease.” The Japanese genre is “self-inflicting/aggravating” on the OF sector, while the Dutch genre is that one sector damages others uni-directionally. And Japan’s present problem with deflationary pressure stems from this origin of the disease.

It should be stressed that the two structurally differentiated sectors are not totally separate, but are interconnected in a variety of ways. For example, the manufacturing side of Japan’s automobile industry is in the OF sector, but its domestic distribution side

and some of its suppliers of inputs are in the ID sector. Japan's automakers established their own networks of exclusive dealerships as well as their own multi-layered systems of parts suppliers. There is little doubt that their tight control on distribution was one important hindrance to car imports. Even though one automaker's exclusive dealership discriminate equally against all other compatriot competitors (hence some argue that it is not discriminatory only to imports), the exclusive dealerships set up by *all* the major domestic producers as a whole surely became a barrier to imports (Ozawa 1996).

Particularly as the result of their exclusive *keiretsu* sales arrangements, Japan's automakers have been able to maintain relatively price-stable and profitable market conditions at home, which until recently was enhanced by Japan's steady macroeconomic growth (Itami 1994). The same situation applies to the consumer electric/electronics goods industry. Thus, the *keiretsu* groups straddle both the OF and the ID sectors. And the OF portion of their business activities often benefit from the ID portion. This may explain, at least in part, why price duality occurred between home and abroad. As Ito and Maruyama (1991) put it,

The *keiretsu*, or whatever structures make possible vertical restraints and resale price maintenance, may segregate the Japanese market from the rest of the world. Then the pricing-to-the-market behavior [export prices are lowered relative to domestic prices in order to limit the effects of currency appreciation] becomes possible, and the Japanese manufacturers seem to exercise this power. In that sense, the distribution system is guilty of causing the price differential between Japan and abroad.

In addition to the *keiretsu*, the more protected the domestic market is, the easier it is for Japanese producers to price discriminate against their home consumers. Price discrimination is a "hidden" form of creating subsidies—that is, let domestic consumers indirectly subsidize exports and domestic production. The OF-ID dual structure provides a mechanism that allows such subsidization (Ozawa 1996).¹³

3.3.2. Excessive outward FDI and the "price-industry-flow (a la David Hume)" syndrome

In the OF sector, the incessant drive to product and process innovations, and notably the spreading of "lean or flexible production" techniques from the automobile industry to other assembly-based OF industries such as electronics, further helped expand Japan's manufacturing exports, causing inevitable trade conflicts overseas. Assembly-based firms (that is, "differentiated Smithian" industries) first set up assembly operations in their core export markets, North America and Europe.¹⁴ This move actually increased Japanese exports of parts and components, further ballooning Japan's trade surplus. In the meantime, the ID sector continued to hinder imports—hence a further appreciation of the yen and an aggravation of the "Japanese disease." The ID-sector-connected

¹³ In the 1970s occurred a consumer boycott against Matsushita TVs, when the Japanese consumers learned that they had to pay much higher prices at home than what the company was charging in its export markets.

¹⁴ For Japanese assembly-based investments in Europe, see, for example, Dunning and Cantwell (1991).

government ministries and politicians continued to protect their own turfs, resulting in a rigidification *a la* Olson (1982) of macro-organizational institutions (Japan's old catch-up regime) and their practices.

The super-yen began to wipe out the price competitiveness of the OF manufacturers. In response, these manufacturers began to transplant more price-sensitive segments of production involving low-end products and standardized parts and components to low-cost countries, mostly in Asia, via foreign direct investment, original equipment manufacturing (OEM), and subcontracting. And Japanese manufacturers in the OF sector began to import from their own overseas ventures and business affiliates. Thus, many once exporting industries in the OF sector have become multinational users of imports—and in fact, become import-promoting due to the appreciating yen. In other words, *paradoxically, it is not so much the ID sector but the initially export-competitive OF sector that has become increasingly more and more import-dependent.*

There is strong evidence that during the abnormally overvalued yen period (over 1985-1995) Japanese firms did transplant production excessively abroad—excessively because some foreign direct investment (FDIs) were induced not so much because they lost *real* comparative advantages, but rather because the abnormally high yen made it *distortionally more costly* to produce at home than abroad. The “price-distortion” effect of the foreign exchange rate was thus the primary cause of the sharp growth in Japan's outward FDI in the 1985-1996 period (actually comprising two surging waves of outward FDI in 1986-1991 and 1994-1996).¹⁵ In other words, FDI was became overwhelmingly a financial manifestation *a la* Aliber (1993) rather than a *real-market* optimization. This meant that Japan became a high-cost country, and many Japanese firms moved out of Japan not so much because they were genuinely attracted to overseas host countries (which offered, say, some promising local markets or truly favorable, first-best industrial milieu) but rather because they had to escape from the ever-increasing cost burden of home-based production.¹⁶ Thus, an orderly transplantation of only comparatively disadvantaged industrial activities was switched to a distortional, premature and disorderly transfer of still comparatively advantaged activities from Japan.

Being scarce in natural and industrial resources, Japan should have benefited enormously from the super-yen, which would surely made Japan's cost structure lower. On the contrary, however, Japanese firms found domestic production even more expensive—and increasingly so—than ever before relative to offshore production. This anomaly was no doubt caused by the over-regulated structure of the Japanese economy. One official study revealed a close correlation of outward foreign direct investment with the “internal and external price differential” over the 1975-1994 period (**see Figure 5**).

¹⁵ This means that the “assembly-transplanting” type of outward investment shown in Figure 1 became exaggerated.

¹⁶ Stephen Hymer's (1960) seminal work emphasized the possession of “advantages,” the “removal of competition” and the “diversification” of business risks) as key motives for investing overseas. And these advantages are supposed to be substantially large enough to offset any cost of doing business overseas; otherwise, firms would stay home. The recent Japanese experience has another motive, a motive to escape from the rising unfavorable costs of home-based production which squeeze profits—that is, the “home-disadvantaged production”.

Interestingly enough, the correlation is observable in not only cyclical but also secular patterns after 1985 onward. An important question is, then, why the price differential has widened as a secular trend, particularly after 1985? Since the yen started to appreciate against the dollar after the Plaza accord, such a strong home currency should have made imports much cheaper for Japanese consumers while making exports more expensive for foreign consumers—in perfect proportion to the degree of the yen’s appreciation if the pass-through effect is perfect (i.e., 100%). The result should have been a reduction in the price differential. The fact that exactly the opposite happened is mainly because Japan’s import markets have been still effectively sheltered if not so much legally (via tariffs and quotas) but by regulations and Japan’s unique structural features which discourage competition. In addition, the prices of nontradables in Japan, another segment of the economy heavily regulated and characterized by many restrictive business practices, also kept rising, further heightening the overvaluation of the yen.¹⁷

The excessive overseas investment compelled by the overvalued yen caused fears about a possible “hollowing-out” of Japanese industry and rising unemployment. In response, Japanese industry kept minimizing the contraction of domestic productive facilities instead of closing down while it simultaneously expanded overseas production. The upshot was a rise in excessive corporate productive capacities, which is now haunting Japanese industry.

In short, it is a paradoxical development, since such a successful and strong industrial buildup in automobiles and electronics at home has been accompanied with precipitous industrial outflows (a threat of industrial hollow-out). The more cost-competitive they became, the greater the need for shifting production from home to overseas. This paradox can be described as the “price-industry-flow” mechanism by paraphrasing David Hume’s (1752) “price-specie-flow” mechanism. Hume stressed the fact that even if a country tries to run trade surpluses and accumulate precious metals by pursuing mercantilist policy, the precious metals thus gained will be drained out of the country, since its domestic money supply (under a metallic standard) will automatically rise, thereby causing inflation and making the initial trade surplus disappear (hence an outflow of precious metals). Similarly, the more successful Japan’s neo-mercantilist industry policy to build up manufacturing at home under protection and promotion was, the greater the upward pressure on the yen and wages at home—amplified by the distortion effect of the OF-ID dual structure; hence, the eventual decline of Japan’s home-based manufacturing. This analogy is surely appropriate, especially in light of Japan’s present struggle to dismantle and reform its 1955-*taisei* or its old catch-up regime.

3.4. The principle of “job primacy over efficiency” as an implicit social contract

¹⁷ Nontradables, by definition, constitutes a completely sheltered sector from international competition. In fact, Japan leads the industrial countries in the rate of price increase of its nontradables, and also leads in the gap in productivity gains between the tradables and nontradables sectors (aside from Norway). These features are revealed in Krugman and Obstfeld (1997: 429). High prices of nontradables relative to those of tradables at home are known to be closely correlated with the overvaluation of home currency, since such price differentials are one significant cause of deviation from the purchasing power parity of currency.

Although Japan did experience a brief period of labor strife between leftist-inspired unionists and management in the very early postwar period, it soon came to develop harmonious labor relations and began to concentrate on rebuilding Japan—especially after the sudden change in the occupation forces’ initially liberal labor policy and the subsequent crackdown on communist-controlled unions with the onset of the Cold War.

What has *evolved* from the early postwar chaos is the unique Japanese style of management and industrial relations, which Ozaki (1991) even called “human capitalism” or the “humanistic enterprise system,” because of its strong emphasis on human resource development. Sakibara (1993: 4) argues that “the fundamental principle underlying the Japanese model of mixed economy is anthropocentrism.” In particular, “lifetime employment,” “seniority system” and “company unions” are normally singled out as the defining characteristics of the Japanese brand of capitalism.

Once an individual is hired by a company, that individual’s job security is guaranteed, if not explicitly, so long as the company continues to exist. Such a “permanent” employee is in turn expected to devote himself totally to the goals and welfare of his company (as a company man) and to be promoted automatically with predetermined pay scales as time goes by, that is, under the seniority system of promotion and compensation. Company profits are distributed in biannual bonuses to all employees. Company CEOs and directors are normally chosen internally. The compensation gap between executives and “run-of-the mill” workers is kept low under the “we-are-all-in-the-same-boat” ideology, which induces cooperation and devotion.

Even as recent as 1993, for example, Japanese executives earned, on average, less than 32 times the pay of the average factory worker (not including bonuses for workers that can boost their annual salaries by a third). This contrasts sharply with American executives who earned roughly 157 times average factory worker’s pay.¹⁸ More recently, this pay differential has surely increased, since American executives, especially CEOs, receive generous—often exorbitant—compensations in stock options. In 1999, the gap jumped to as much as 419.¹⁹

Of course, in the war-devastated early-postwar Japan economy collaboration and cooperation were, on the whole, a necessity for survival rather than a choice. But Japan is also basically an egalitarian society, and Japanese businessmen have been traditionally beholden, with a strong sense of loyalty and obligation, to their own group and subordinates. Unlike American society which is strongly embedded in individualism, self-centered and opportunistic behavior is not looked upon favorably in Japan. Hence, against the backdrop of the adverse economic conditions right after the war, the Japanese company came to be organized and governed as a multi-stake *sharing unit*, representing the interests of its employees (in job security and income), its creditors (in loan obligations) and its suppliers (in steady and reliable orders for sub-assemblies, parts, components and accessories)—in addition to the stake of its stock holders (in long-term

¹⁸ Based on the results of a survey published in “Executive Pay: the party ain’t over yet,” *Business Week*, April 26, 1993, p.60.

¹⁹ “Share Options,” *The Economist*, August 7, 1999, pp. 18-20.

corporate growth as “patient capital”). This feature is called “stakeholder model” and identified as “shared growth” by the World Bank (1993) when it explored the secrets of what it called “The East Asian Miracle.”

A sanguine, but quite relevant, view of Japanese-style capitalism is presented in Ozaki (1991: 10):

The Japanese system embraces a humanistic economic philosophy, based on three propositions: (1) human resources are the most important factor of production and are the ultimate origin of the market value of all goods produced; (2) people, unlike nonhuman resources, are intellectual (intelligence-carrying) beings in that they are capable of thinking, analyzing, inventing, innovating, and developing information vital for the creation of wealth; and (3) people are psychological (emotional) beings whose productivity may rise or fall depending on whether they are motivated or demoralized by their work environment. These three principles—in reality obvious truths—define what we call “human capitalism.”

Indeed, one may argue that without such a “humanistic” orientation of the Japanese system the now-world-renowned “flexible production” paradigm would have never seen the light of the day during the “differentiated Smithian” stage of assembly-based industrial development. This new production paradigm is also called “Toyotism” as opposed to “Fordism-Taylorism.” What is especially revolutionary about it is the activation of intellectual capabilities of shop-floor workers; they are no longer treated merely as “brawn workers” who only take orders as under Fordism-Taylorism but considered as “brain workers” who can figure out operational problems they encounter every day, suggest ways of solving them, and keep improving their own work processes. Aoki (1988) calls this phenomenon an active use of the “information-processing capacity” of workers. This practice soon spread to other industries and a variety of flexible production came to be innovated throughout Japan’s manufacturing sector. The Japanese approach to human resources at corporate level compared to the U.S. approach is summarized in stylized form in Figure 6. (See **Figure 6**)

In short, Japan’s labor relations which have thus evolved and contributed so much to the phenomenal growth in labor productivity are institutionalized as a national asset and cannot be easily dismantled just for the sake of showing a favorable *immediate/near-term* “bottom line” by cutting payrolls so as to please investors in the stock market. The Japanese simply cannot put the livelihood interest of workers behind the pecuniary interests of financiers or rentiers. And this cultural trait or “belief system” needs to be taken fully into account when one wonders why corporate Japan is so “indecisive” in carrying out institutional reforms (or becoming more like the U.S.).

4. MUDDLING THROUGH

4.1. Foreign Multinationals to the Rescue?

Postwar Japan resisted any foreign ownership of domestic industries as a conduit of technology learning. Instead, it encouraged and relied on licensing agreements and other non-equity form of knowledge inflows. Imported technologies were essentially looked upon as “raw materials” further to be processed and perfected /commercialized at home—and eventually exported back to the world (Ozawa 1974). If foreign investments ever occurred, they used to be exceptions, exceptions that were made largely because of some unusual circumstances or considered in national interests. For example, IBM Japan, an early postwar investment, was an yen-based investment permitted before the restrictive Foreign Investment Law of 1950 was enacted (an unusual case); it was also considered essential for its technological spillovers (a national-interest-compatible case) (Ozawa 1986). It was also only after the Japanese economy had begun to gradually open its market in the late 1960s that some more cases of inward investment (such as Chrysler’s minority stake in Mitsubishi Motor and GE’s in Isuzu) were observed.

As Japan’s precipitous outward FDI occurred as a function of its rapid structural transformation and the ever-appreciating yen, the above-described restrictions on inward FDI inevitably led to a lopsided negative balance on its FDI account. Japan came to be criticized as an unfair FDI regime that one-sidedly exploited overseas opportunities for corporate expansion while closing off its own market for foreign MNCs.

Unthinkable events, however, began to occur after the bubble burst of 1990. Nissan Motor Company, Japan’s number-two automaker, came to be managerially controlled by Renault of France and has been on its way to an impressive turnaround under its French CEO’s direction. Yamaichi Securities, Japan’s oldest but bankrupted firm in 1997, was acquired by Merrill Lynch. And the Long-Term Credit Bank of Japan, one of Japan’s erstwhile three quasi-public institutions designed to provide long-term loans to infrastructural projects (along the Japan Credit Bank and the Industrial Bank of Japan) was bought up by the Ripplewood Holdings and its affiliates and renamed to Shinsei Bank. Japan’s distribution sector, once off-limit to foreign investors, is now ‘crowded in’ by a number of large-scale distributors/stores, such as Toys ‘R’ Us, Office Depot, the Gap, Boots (British drugstore chain), Sephora (French cosmetic retailer), Starbucks Coffee, Carrefour SA (Paris-based grocery retailer) and Costco Wholesale. These investments were indeed unthinkable only a decade ago. They are injecting fresh air to otherwise-stale Japanese management not only in those foreign-acquired firms but also in the entire economy at large. The floodgate is now open, and inward FDI in Japan has been sharply on the rise, especially in mergers and acquisitions as Japanese companies struggle to get rid of unprofitable non-core business operations. Foreign MNCs are now looked upon as an agent of institutional change and business restructuring. And interestingly enough, their investment activities are picking up in *exactly* those industries that have long been sheltered from competition, namely in the ID sector itself.

4.2. The Imperative of the Net-driven New Economy

Moreover, the advent of the New Economy is abruptly thrusting Japan onto a new stage of growth, a stage that is intensive in the use of information technology (IT) and intellectual capital. This new stage is concentrated on producing “abstract or conceptual

goods” and that may therefore be identified as “McLuhan” (after the media guru Marshall McLuhan—for lack of a better nomenclature at the moment) in contrast to the earlier (Old Economy) stages of catch-up growth where more tangible inputs were intensively employed as resources to produce tangible/physical goods (Ozawa 2000b, 2001).

The “McLuhan” phase being born in the United States where the Internet-driven boom originated in an unregulated, no holds-barred environment. The Net-driven New Economy has been a creature of America’s free-spirited, free-market system with an equally free-wheeling stock market. Indeed, it is a long-term combined outcome of deregulation, trade liberalization, and a more flexible labor market, and coalescing technological changes. It took the United States about two decades to establish a New Economy. In particular, capital markets (venture capital, equities, IPOs and M&As) have been an indispensable financial ingredient of the unprecedented U.S. economic boom. Because the emergence of a New Economy thus owes to drastic deregulations and free-market plays in the U.S, its spread to Japan has already had a significant impact on Japan’s *dirigiste* regime, especially in the areas of telecommunications, finance and distribution. Along with inward FDI, thus, the New Economy provides an autonomous (market-driven) momentum for Japan to deregulate its business environments so as to promote entrepreneurial Internet ventures.

Most interestingly, the Net revolution will thus have its greatest impact on Japan’s erstwhile heavily protected ID sector for two important reasons: first, a successful Net revolution requires deregulation and free-market transactions, and second, an application of IT enhances transactional efficiency and productivity. Therefore, *the more archaic, distorted, and inefficient an industry is, the greater the potential gains from the Net revolution, hence the faster the potential productivity growth.* In this respect, Japan has a huge backwater of still regulated and protected industries (namely in the ID sector) which are now beginning to open up for global competition in trade and MNCs’ investment.

One prime example in this regard is Japan’s suddenly growing cellular phone (wireless telecommunications) market which now boasts the world’s largest number of subscribers (around 20 million at the end of 2000) to the mobile-Internet services delivered over the I-mode of cellular phones. This domestic advantage put Japan far ahead in the race to commercializing this fast-growing technology into third-generation (3G) cellular services.

What is surprisingly little known, however, is the fact that the United States forced Japan to deregulate the cellular phone market in 1994 so as to support American telecom multinationals’ advance into the Japanese market. Up until then, Japanese citizens were *not* even permitted to own personal cellular phones. Besides, Japan thought that once the market was to be deregulated, its local companies would quickly lose business to American rivals like Motorola, which had popularized cellular phones much earlier. Be that as it may, thanks to the *gaiatsu* [external pressure] for deregulation exerted by the United States, Japan finally opened up this particular market and serendipitously leapfrogged to the forefront of the global race to the wireless Internet and e-commerce

(now mobile- or m-commerce in which buying and selling goods take place over the Internet from a mobile phone).

Japan has long been known as an excellent emulator, as demonstrated in its effective FG strategy. And the advent of the Net age is providing another unique opportunity to play catch-up. Wireless Web may be the future of the digital economy rather than fixed-line Web. Sensing this godsend opportunity, Japan just began to mobilize itself once again as it did previously in its successful catch-up efforts. In September 2000, its newly formed 20-member IT Strategy Council, chaired by Sony's president, and composed of other notable captains of industry such as Toyota Motor Corp., Softbank and IBM (Japan), announced an ambitious goal to catch up and surpass the United States in the Internet economy in five years. To achieve this national goal, the Council urges the government to dismantle all the institutional obstacles (i.e., business-hampering regulations) to the growth of a New Economy. Japan has a solid production base of Internet artifacts, including telecommunications equipment, fiber optics, and digital goods. Another round of catch-up may have just begun.

Indeed, the Japanese frustrated by a lost decade of growth see a promise of revitalizing their economy in deregulations, and criticize the government for its slow pace of implementation. Simultaneously, however, they feel apprehensive of the direction in which Japan moves forward. From a Western/Anglo-Saxon perspective, it is easy to say casually, for example, "Unviable firms have foolishly been kept alive with bailouts, rather than being broken up or allowed to go bust,"²⁰(as cited earlier).

Since the Internet-driven McLuhan stage is so new and recent, having taken root first in the United States, a unique Net-enabled economy model, which is specific to the prevailing socio-political, economic conditions in the U.S. has come into being. Although the U.S. economy is now on a downturn, it has experienced, at least until very recently, the virtuous circle of "IT innovations → productivity growth → stock market gains → consumption and investment expansion → productivity growth." There are a "virtuous" circle of synergistic interactions between the real economy and wealth creation. This American model has recently resulted in skill shortages (hence, dependence on skilled immigrants), ever-rising trade deficits, debt overhang and a rising income gap. In fact, a high-tech bubble burst has occurred. The "virtuous" circle may easily turn into a vicious circle.

Besides, the unbridled free-for-all competition formula used for wireless license bidding—and subsequent Net manias for investment expansion—in the U.S. and Europe led to a hangover of debts (mostly finance via junk bonds and the once-high-flying stock markets) and financial weaknesses in their telecom industry. This now threatens a financial meltdown, which some consider "could turn out to be almost as costly as the savings and loan bailout."²¹ Although the U.S. and European governments reaped windfalls from auctioning off licenses for 3G services, the winning bidders ended up in huge debts. In marked contrast, the Japanese government simply chose three companies

²⁰ "The danger of delay," *The Economist*, March 31, 2001, p. 17.

²¹ "Telecom Meltdown," *Business Week*, April 23, 2001, pp. 100-110.

on the basis of their qualifications—without causing any financial burden on them. And here is an early harbinger of the way Japan has already started to depart from the Western model.

Be that as it may, the Japanese are hesitant to whole-heartedly take up the principle of unfettered competition and the social values embedded in American-style capitalism. Corporate Japan perhaps envies America's "flexible" labor market which allows companies to lay off as they see fit. Fully pursuant to the logic of its FG strategy, Japan has already been quite "Americanized" by choice in its physical and technological characteristics and consumer tastes (notably of the younger generations), but not yet so much in its human resource management approach, concerning treatment of employees. Japan is thus in an institutional quandary; it does not have a clear-cut role model to follow and has to craft its own system.

Yet, the NIEs in particular are liberalizing their economic regimes in conjunction with promoting e-commerce and are eager to take over Japan in the race to the Internet-driven New Economy. Hence, Japan can no longer afford to sit still or remain procrastinated in eliminating any persistent remnants of the old *dirigiste* regime.²² In fact, there are some rising fears that Japan is falling in the online rush behind the NIEs. Hong Kong and Singapore have sharply reduced telecommunications costs through drastic deregulation of the market. Both enjoy the advantages of their advanced information infrastructure and English skills. Hong Kong has built "Cyberport," an IT business center. Singapore has begun to wire up a substantial part of its economy with high-speed Internet networks. Taiwan's cable-television networks with an 80% coverage of the island's households are capitalized on to offer cheap and fast online connections. South Korea's households with over 60 percent of them having a personal computer are active online traders, accounting for nearly 70 percent of all securities transactions. South Korea is said to be in a higher stage of Internet development than any other Asian economies; "Korea's e-business market is projected to be 2.5 times the size of China's by 2005, and larger than the combined markets of Singapore, the rest of Southeast Asia, India, and Hong Kong" (Ernst 2001:6).

Furthermore, overseas Chinese business communities throughout East and Southeast Asia, along with their mainland counterparts in China, are building up an Asian-wide cyber-network underpinned by a common language and culture. The overseas Chinese entrepreneurs are comfortable with aggressive American business models, since many of them are U.S.-educated and Silicon-Valley-trained.²³ Given these rapidly emerging Net

²² As of end of November, 2000, the Internet-access costs per month stood at \$67.12 (\$42.13 in telephone charges + \$24.99 in Net service provider charges) in Japan, compared to \$22.45 in South Korea, \$19.57 in Taiwan, \$31.78 in Hong Kong, and \$30.05 in the U.S. "Korean IT firms gain foothold in Japan," *The Nikkei Weekly*, Dec. 25, 2000-January 1, 2001, p. 1.

²³ These developments in Asia are emphasized in an editorial of the *Nikkei Weekly* (August 28, 2000, p. 6). It also warns that "Asian information-technology leaders seldom talk about Japan. Companies owned by overseas Chinese are leading online business growth throughout Asia." Also, *The Economist* (June 10, 2000, p.5) put America at the head of the field in readiness for e-business, while it ranked Japan 21st (the lowest-ranked G7 country) way behind Singapore (8th ranked) and Hong Kong (9th ranked).

economies in its neighbors, Japan could easily be left in the dust unless it also quickly adapts to the imperatives of the New Economy.

The Old Economy catch-up sequence from textiles to steel, to automobiles and computers, and to super-chips and biotechnology (that is, from the “Heckscher-Ohlin” through the “Schumpeterian” stage) has been rather *linear* and *gradual*, each stage building largely on the previous stage’s experiences with successful industrial development and knowledge accumulation. In contrast, the New Economy (the “McLuhan” stage) impacts all the previous-stage (Old Economy) industries simultaneously along the corporate value-added chain of knowledge creation and production. Old Economy industries have to adjust themselves by adopting IT to be connected or wired with the emerging New Economy through the Internet. Moreover, the non-manufacturing service sectors such as banking, finance, insurance, telecommunications, wholesale and retail businesses, and government services are most dramatically impacted. The Internet-enabled McLuhan stage thus seeps through and permeates the entire economy; its impact is nonlinear and revolutionary.

Furthermore, all the required hardware (artifacts) can be easily imported from overseas and installed to enter the McLuhan stage; a relatively easy task for developing countries to perform if they have an institutional mix suitable for the New Economy. This may explain why other Asian economies see an opportunity to take over Japan—and eager to do so—in building an Internet-based New Economy. The fact that the service sector is most amenable to the Internet may explain why Hong Kong and Singapore are way ahead of Japan, which is still dragged largely by the political burden of the ID sector. The whole Asian rush to the New Economy is schematically illustrated in terms of the FG paradigm of industrial upgrading (See **Figure 7**). Japan is thus forced to follow suit in deregulating its economy.

5. SUMMING UP

Japan was once successful in pursuing the FG strategy of catch-up growth. In fact, it enjoyed high growth (a growth rate of about 10 percent annually) during the so-called Golden Age of Capitalism (1950-1974) by capitalizing on the favorable global environment, especially in the context of stable exchange rates (under the original IMF system) and intensification of the Cold War. In those years the United States opted for a foreign policy in favor of security, even at some cost to its own economic interests, to ensure Asia’s “continuous orientation toward Washington” (Cumings 1984). This policy allowed Japan an opportunity to harvest benefits from America’s liberal trade regime, the opportunity to pursue *dirigiste* capitalism or FG catch-up.

Japan’s *dirigiste* catch-up regime was quite effective in facilitating rapid industrial upgrading at home without creating foreign ownership of domestic industries. This regime worked nicely up until the late 1970s Japan had by then gone through heavy and chemical industrial modernization (i.e., “nondifferentiated Smithian” stage) and begun to build up assembly-based, component-intensive industries, notably cars and electronics (i.e., “differentiated Smithian” stage).

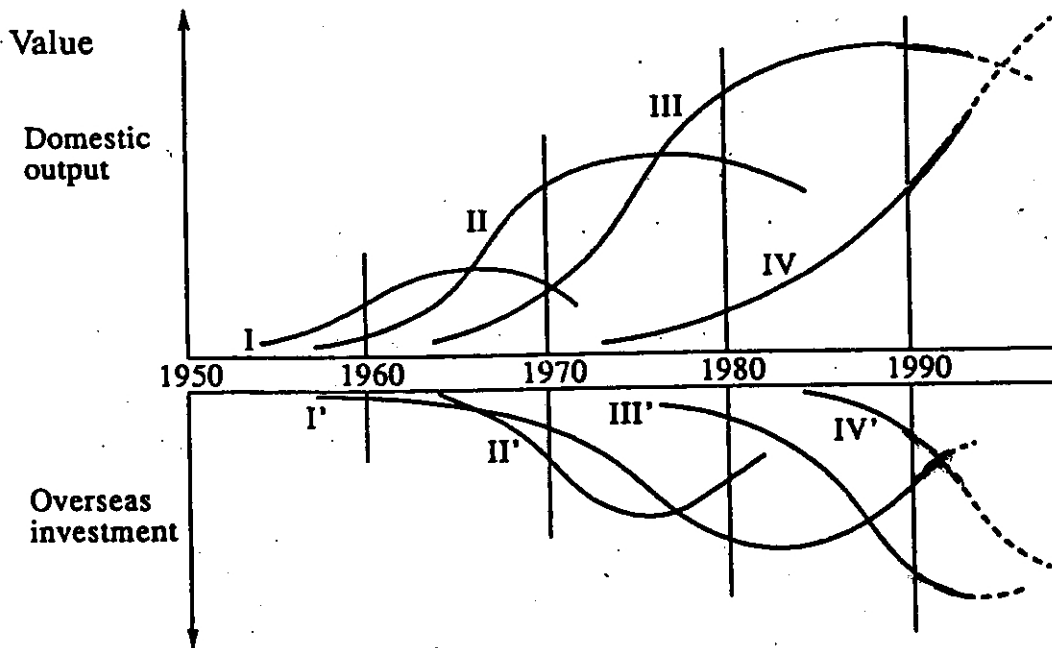
The catch-up regime was built on a unique set of four key institutional arrangements: state-directed bank-based finance of development (the main bank system), *keiretsu* formation, the ID (“pork barrel”) sector, and Japanese-style management. This institutional setup proved quite effective in inducing quick technological absorption, productivity increases and adaptive innovations. Learning occurred mostly in the form of licensing agreements. But, as Japan succeeded climbing the ladder of industrial development, these arrangements quickly became not only obsolete but more importantly obstructive to further growth. Bank-loan capitalism resulted in the 1987-1990 bubble and the present prolonged banking crisis. The growth of a dual industrial structure (OF vs. ID) led to huge trade surpluses, sharp appreciations of the yen, and lopsided outflows of investment (both FDI and portfolio). Constrained by its social contract for job security, post-bubble Japan ended up with excess capacities, causing downward pressure on prices. Liberalization of imports in the distribution sector added to this woe. And all of a sudden, Japan found itself in a deflationary spiral.

The bank of Japan’s dramatic change in its monetary policy is intended to stem the current deflation. Various schemes including the establishment of a fund to purchase the shares unloaded by banks (the result of unraveling of cross-share holdings) have been proposed and debated by the government. But politicians dilly-dally and are averse to enforcing painful reforms, especially on their “pork-barrel” ID sector. In the meantime, however, a suddenly rising tide of inward FDI (foreign multinationals’ direct participation in Japanese industry) and the mandate of the New Economy are cajoling corporate Japan, perhaps most effectively than anything else, to deregulate and set its institutional arrangements more compatible with the norms of global capitalism. In fact, Japan is paradoxically “advantaged” in gaining from liberalization and institutional reforms and adopting an Internet-driven New Economy for the very reason that it still has a backwater of inefficient industries in the ID sector (such as finance and insurance, distribution, construction and other services). Japan is clearly in the midst of a new catch-up into the “McLuhan” stage of growth.

**Figure 1. Japan's industrial upgrading and overseas investment:
comparative advantage recycling as a resource-reallocative
mechanism**

Stages of industrial upgrading (a leading-growth-sector model)

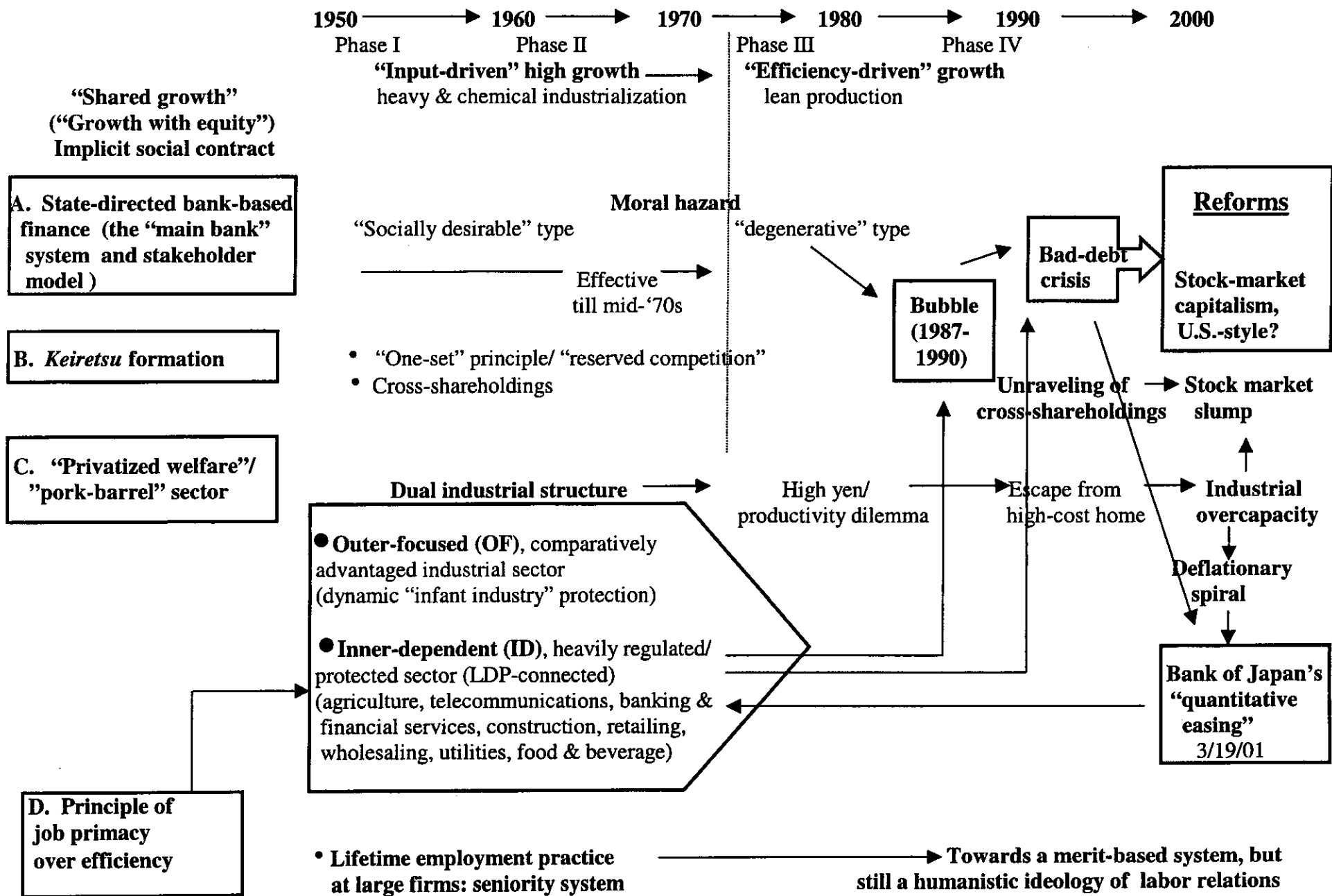
- I Labor-driven "Heckscher-Ohlin" industrialization (e.g., textiles)
- II Scale-driven "nondifferentiated Smithian" development (e.g., steel)
- III Component-intensive, assembly-based "differentiated Smithian" manufacturing (e.g., autos and early-generation electronics)
- IV Innovation-focused, R&D-intensive "Schumpeterian" industries (e.g., new materials, biotechnology, and latest-generation electronics)

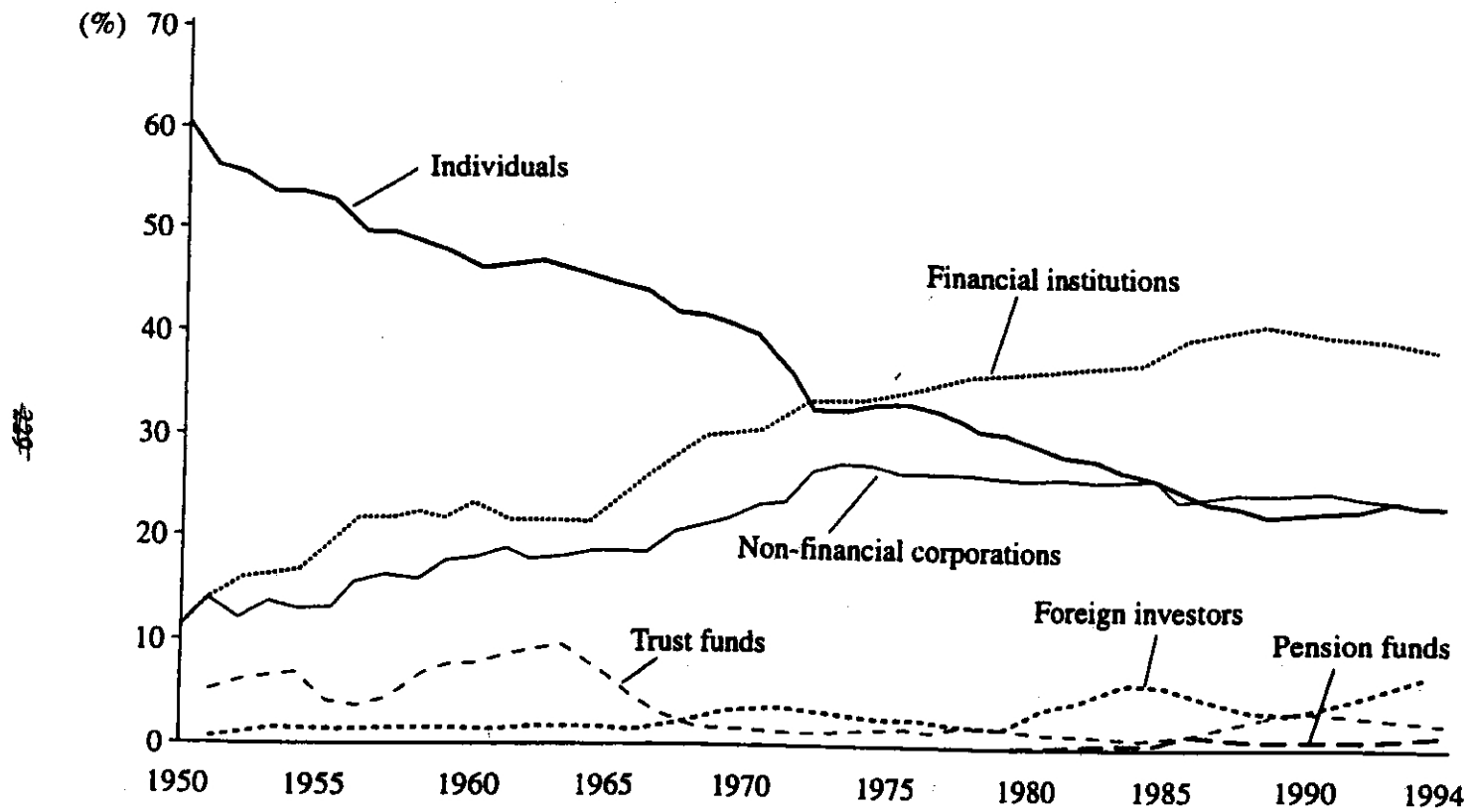


Phases of overseas investment

- I' Low-wage-labor-seeking investment
- II' Resource-seeking and house-cleaning investment
- III' Assembly-transplanting investment
- IV' Strategically networking (alliance-seeking) investment

Figure 2. The *dirigiste* catch-up regime (“institutional matrix”) of Japan’s FG development

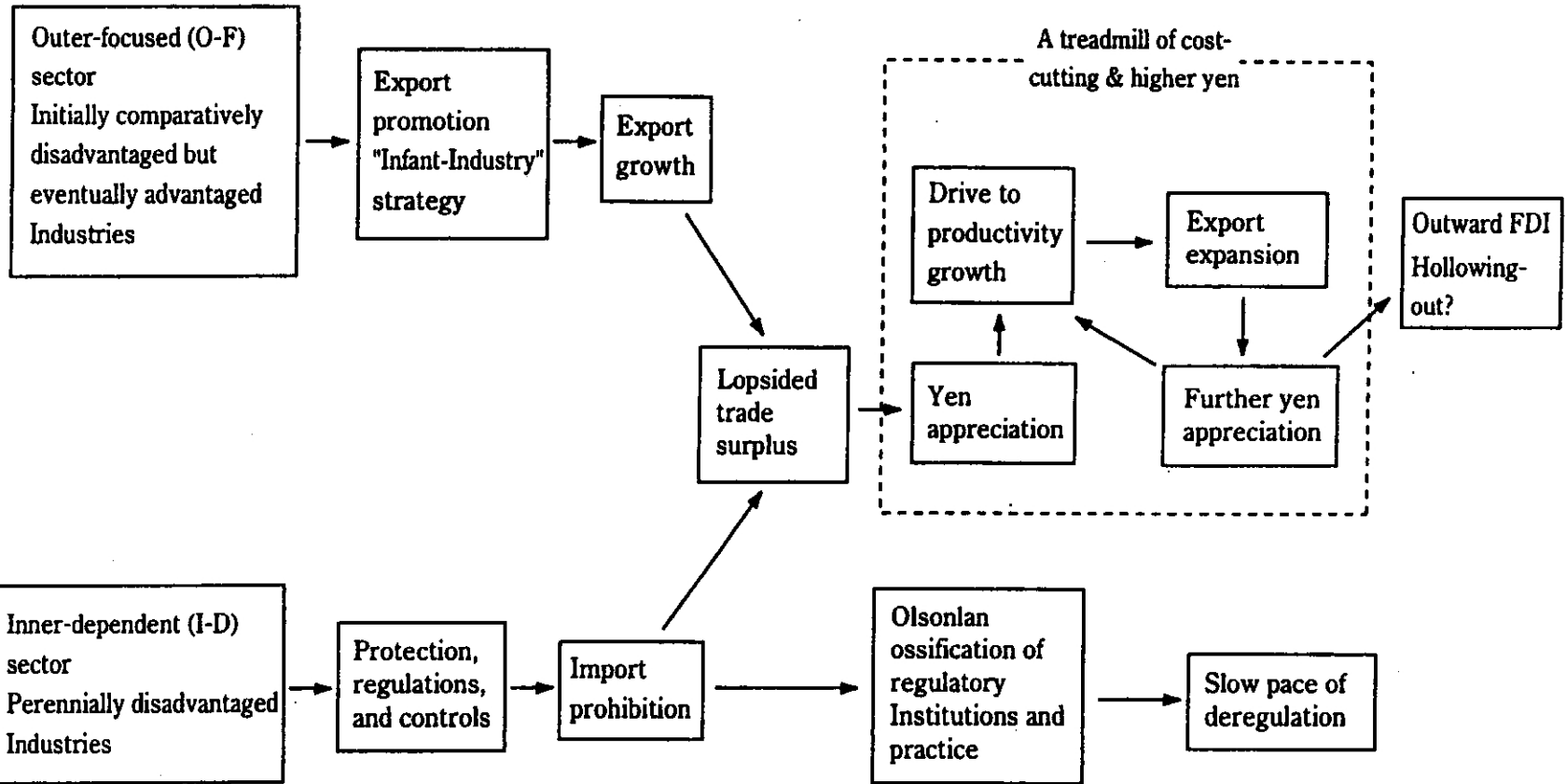




Source: JETRO, White Paper on International Trade, 1995.

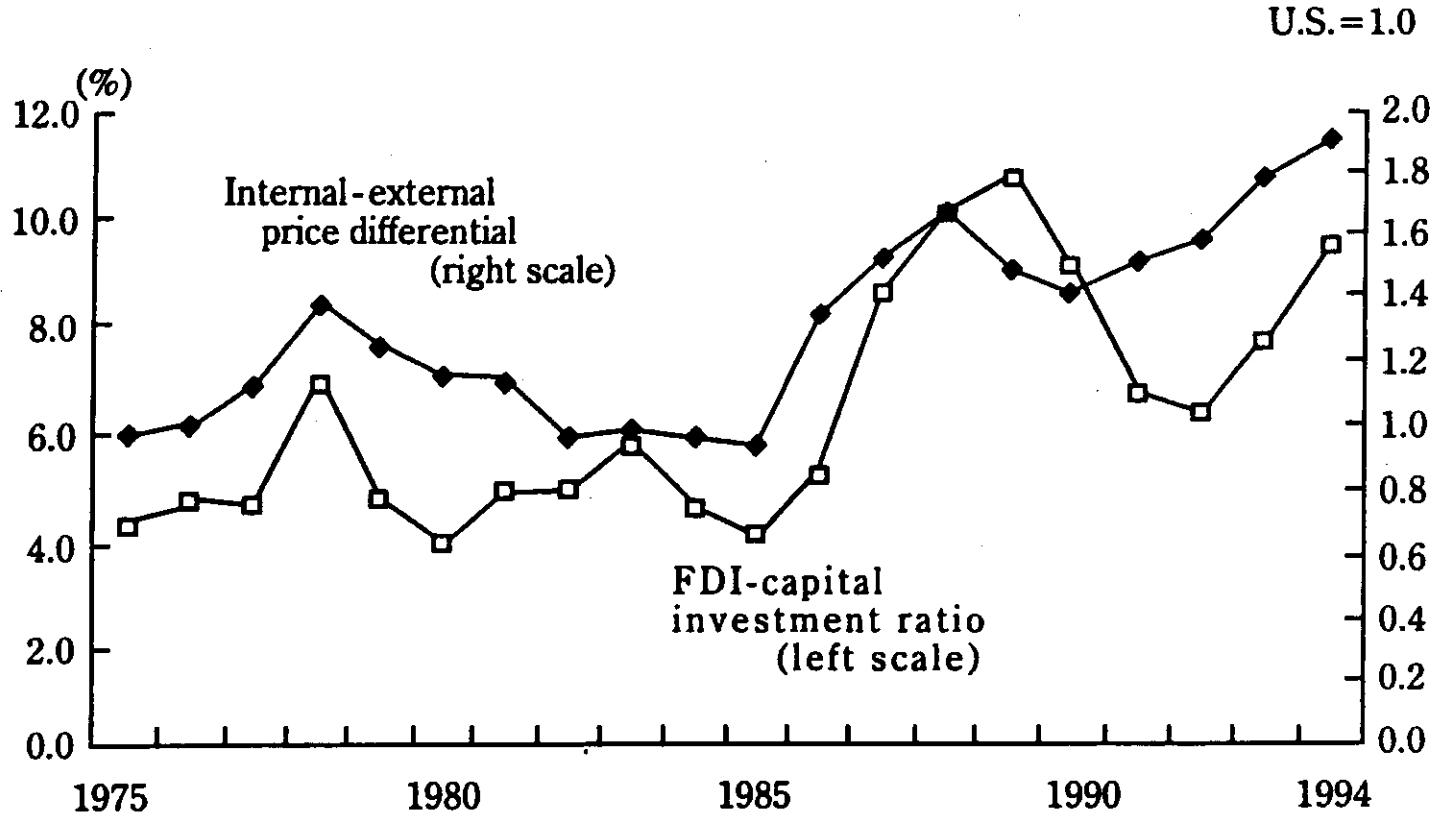
Figure 3. Ownership distribution of Japanese stocks by holder

Figure 4. Structural dualism and the “price-industry-flow (a la David Hume) syndrome”



Source: Ozawa (1996).

Figure 5. "Internal and external price differentials" and foreign direct investment



Source: Small and Medium Enterprise Agency (1996, p.268).

Figure 6. Human-centered capitalism vs. finance-centered capitalism

**Human-centered capitalism,
(Japanese model)**

- Corporations exist for the benefits of people (human resources) that are the ultimate origin of the market value of all goods/services produced. (*Stakeholder* value maximization)
- Workers, unlike nonhuman resources, are “investment assets” that possess intelligence and a vital capacity to develop information for wealth creation. They are a “fixed input” (to be properly “maintained,” “re-trained,” and “renovated.”)
- Company-specific assets and not easily interchangeable.
- Unlike nonhuman resources, people are psychological (emotional) beings whose productivity is swayed by emotions and reactions to their work environment.
- Job stability over near-term efficiency



“Inflexible” labor market

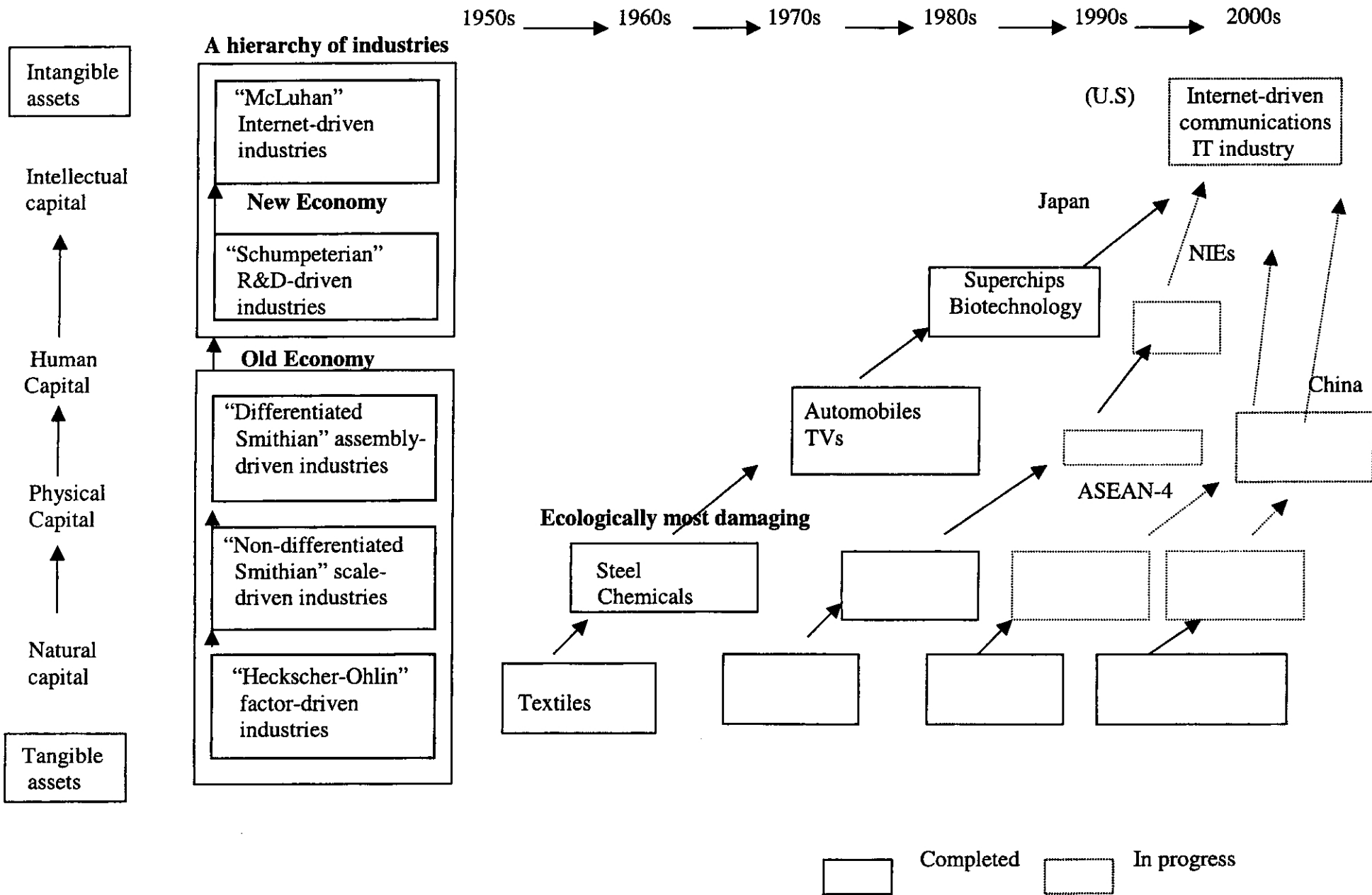
**Finance-centered capitalism,
(American model)**

- Corporations exist for the benefits of financiers/investor owners. A “bottom-line” obsession (*Shareholder* value maximization)
- Workers (labor) is one of three primary factors of production (along with land and capital). They are a “variable input,” whose use is fine-tuned via continual hiring and firing
- Labor is easily replaceable and interchangeable.
- Efficiency/profitability over Job security



“Flexible” labor market

Figure 7. The F-G paradigm of structural upgrading in Pacific Asia and the advent of New Economy



Source: Ozawa (1993, 1997, 2001)

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