

The East Asian Developmental Model in the Era of Global Finance: The Case of Japan

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In this article, I explore the question of whether globalization has attenuated “Asianess” in relation to a central issue at the intersection of political economy and Asian studies. I examine whether and to what extent the long-celebrated East Asian developmental state model has been discredited, both in theory and in practice, as a result of economic globalization and the alleged triumph of neoliberalism. By focusing on the case of Japan, I argue that efforts to recreate and maintain a more liberalized market in the current era have entailed more, rather than less, state activity in many key areas of the economy. In order to demonstrate this point empirically, I focus on Japan’s macroeconomic policies and financial policies since the early 1990s.

Japan & the Neoliberal Economic Paradigm

Nearly three centuries ago, Sir Isaac Newton (1643–1727) remarked, “I can calculate the motion of heavenly bodies but not the madness of people.”¹ His comment followed the dramatic rise and fall in the stock market value of the South Sea Company in 1720. On January 1, 1720, one share of South Sea stock was worth £128. Over the course of the next six months, a speculative frenzy drove prices up as high as £1,050. By September, however, the bubble burst, and the ensuing rush to sell off the company’s stock drove the price back down to £128 by December.

At first glance, beginning an article that focuses on the political economy of contemporary Japan with an incident that occurred in Britain almost three centuries ago may seem odd, but there are in fact two important reasons for doing so. First, the South Sea Bubble is a classic example of a speculative market gone awry that mirrors the single greatest economic challenge Japan has confronted in the last fifty years. Fueled by a speculative frenzy, the stock and real estate markets in Japan rose spectacularly in the second half of the 1980s, only to have these markets come crashing down in the early 1990s. In turn, as assets plummeted and borrowers de-

faulted on their loans, some of Japan's largest financial institutions over the next decade and a half declared bankruptcy, while others, struggling to resolve their staggering levels of non-performing loans, cut back on the creation of new loans. The result has been a prolonged period of economic stagnation and a stark reevaluation of the once-celebrated Japanese model of development.

Second, Newton's remark about the South Sea Bubble illustrates the fallibility of even the most rational of thinkers to explain and predict market behavior. Newton made his observation about the "inability to calculate the madness of men" not simply as an outside observer but as an active participant in this speculative market. Newton originally invested £7,000 early in the year and sold his share in April for a 100 percent profit. But upon watching the stock continue to rise, he reinvested an even larger sum and ultimately lost over £20,000 when the bubble burst.²

No one can accuse Newton, one of the leading representatives of the British Enlightenment, of lacking rational capacity. Moreover, as Great Britain's Master of the Mint from 1699 to 1727, he was clearly knowledgeable about monetary affairs.³ The fact, therefore, that he not only acknowledged an inability to explain market behavior but also was himself a participant in this irrational behavior underscores one of the primary purposes of this article—namely, to call into question both the triumphalism and veracity of today's dominant neoliberal economic paradigm. This paradigm argues, first, that one can explain and predict the economic behavior of market participants based on rational-actor models and assumptions and, second, that the outcome of such behavior in an economic system based on *laissez-faire* principles will necessarily produce the greatest good for the greatest number of people.

With the dramatic spread of global finance, this neoliberal economic paradigm has become an increasingly pervasive view that structures the way we look at the world. Indeed, even those who now occupy opposite ends of the political spectrum often draw similar conclusions about the triumph of neoliberalism in an era of global finance. On the right, economic conservatives, who draw their inspiration from the anti-statist tenets of nineteenth-century liberalism, celebrate the spread of global capital because it allegedly enhances economic freedom and disciplines the state to adopt market-friendly measures.⁴ In contrast, many on the political left lament it precisely for those very reasons: greater economic freedom gives large asset holders of mobile capital greater voice and power in the political arena that will presumably erode democratic practices and weaken the state's ability to address the widening gap in democratic legitimation.⁵ Although each side clearly holds a different normative position about the current state of affairs, both sides seemingly take as a "matter of fact" the erosion of the state and the triumph of neoliberalism in an era of global capital.

This trend can be seen even in the case of Japan, a country that had followed an alternative model of development with tremendous success during the early decades of the postwar period. The model was predicated on the assumption that a strong and autonomous state pursuing developmental goals could achieve better economic results than a state guided by neoliberal principles that adopted a *laissez-faire* approach to the market.⁶ In the first four decades of the postwar period, this model delivered on its promises: Japan's economy grew faster than those of all other advanced industrial democracies while maintaining a relatively low level of unemployment and a high level of income equality. By the early 1980s, however, a clear shift toward conservatism emerged in Japan that was similar to those taking place in other advanced industrial democracies. Just as Great Britain under Thatcher and the United States under Reagan ushered in new conservative regimes, the Japanese government, under the leadership of Prime Minister Nakasone in the 1980s, embraced a conservative neoliberal ideology that ardently called for privatization, deregulation, and a small government.⁷

This neoliberal trend has become even stronger after the speculative bubble collapsed in the early 1990s. With the economy sliding into a prolonged period of stagnation, the predominant interpretation of both the cause and the cure of Japan's economic malaise has been one that is based on neoliberal arguments and assumptions. According to this view, the cause of the malaise is the continued legacy of a strong and activist state inherited from Japan's developmental model. The cure is to conduct structural reform and scale back the state so that the market can make more efficient decisions about how scarce resources are allocated.⁸ Hence, even in the case of contemporary Japan, neoliberalism has become the orthodoxy.

In this article, I question this orthodoxy both in general terms and as it is applied specifically to the case of Japan. I argue that this orthodox neoliberal perspective offers, at best, only an incomplete picture of the relationship between the state and the market that serves to obscure the state's ongoing involvement in the economy. I contend that this picture is incomplete, because a market based on *laissez-faire* principles still needs the state for both its creation and its maintenance. Just as the seminal work of Karl Polanyi (1886–1964) demonstrated that the road to the classical liberal market in the nineteenth century was paved by the strong hand of the state,⁹ I argue that efforts to recreate and maintain a more liberalized market in the current era have entailed more, rather than less, state activity in many key areas of the economy.

An inherent contradiction thus exists in the neoliberal position with respect to the state: it seeks to protect the sanctity of the market from the encroachment of the state, but the market itself needs the state to serve as both midwife and caretaker. The state serves as a midwife because a free market emerges not *de novo* but through laws and regulations created and

enforced by the state.¹⁰ It serves as caretaker because, after a free-market system is established, the state not only mitigates the social costs of economic dislocation but also adopts economic policies in an effort to manage the cyclical challenges of a market economy. Given its emphasis on anti-statism, however, the neoliberal perspective is blind to these issues, and the hidden hand of the state masquerades as the invisible hand of the market.

Accordingly, the central normative claim of this article is that the anti-statist tenet of neoliberalism is a myth that has narrowed unduly the sphere of political agency and democratic choice. To be sure, conservative critics are correct in arguing that resources are finite and that democratically legislated policies require resources that otherwise could have been allocated through the market. But thereby to eschew government activity in favor of an “unfettered” market represents a false dichotomy, because the state plays a prominent, though often hidden, role in creating and maintaining such a market.

Although Japanese government leaders have increasingly embraced the anti-statist rhetoric of neoliberalism, the policies they have adopted have actually increased, rather than decreased, the presence and the activity of the state in the market. I demonstrate this point empirically in the next section. I focus on two main issues: Japan’s macroeconomic policies and financial policies throughout the 1990s. These issues represent two of the most important points of contention concerning the erosion of the state—and erosion of democracy—in an era marked by the spread of global finance and the triumph of neoliberalism.

The State in Japanese Macroeconomic & Financial Policy

In the contemporary era, conventional wisdom suggests that economic globalization will compel states that have hitherto pursued different economic models and strategies to converge toward the “best practices” of a liberal market system. Nowhere is this argument more forcefully stated than in the two broad policy areas examined in this article. In the realm of macroeconomic policy, the neoliberal position argues that the dramatic globalization of the international capital market will restrict the government’s ability to adopt Keynesian fiscal policies, because mobile asset-holders become more capable of exercising their “exit” threat on governments that fail to minimize the size of the state and adopt more “market-friendly” measures. Moreover, since international financial investors deem governments with large budget deficits to be less credit worthy than those that have their fiscal houses in order, the competition to attract global capital encourages governments to retrench and adopt more stringent budgets.¹¹

A similar argument is made in the realm of financial policy. In both popular and scholarly accounts, many portray the dramatic globalization of

the international financial market as a force that has eroded the authority and autonomy of sovereign states. According to this view, regulatory barriers to international capital are increasingly costly to erect, both politically and economically. Greater capital mobility, transnational linkages, and the growth of international market structures are seen to introduce a competitive system wherein transnational actors exercise more power over states by utilizing greater “exit” threats—and where states often undermine their own regulatory powers willingly in order to attract “footloose” capital flows.¹² Hence, even in the case of East Asia, where the developmental state model had posed a serious challenge to classical liberal orthodoxy, the financial crisis that has plagued this region in the 1990s is now seen as evidence of the need to withdraw the visible hand of the state and adopt greater free-market reforms.¹³

At the rhetorical level, Japan has not been immune to these trends. Although the country had adopted an alternative model of development with notable success since the early postwar period, the Japanese government, under the leadership of Prime Minister Nakasone, began to embrace in the early 1980s a conservative neoliberal ideology that called for privatization, deregulation, and a small government. Accordingly, in the realm of macroeconomic policy, the strategy advocated by the political party in power, the Liberal Democratic Party (LDP), was one that ostensibly repudiated Keynesian fiscal strategies in favor of monetarism. With respect to financial policy, the government began to call for the gradual liberalization of the Japanese financial market. Moreover, in the following decade, after the Japanese economy slid into a prolonged period of stagnation following the collapse of the stock and real estate markets, this neoliberal perspective has become an increasingly prominent position of the political party in power.

A closer look at the empirical evidence, however, reveals that there is a wide discrepancy between the government’s rhetorical commitment to neoliberal reform and the actual policies that have been adopted. To be sure, there were elements in both macroeconomic policy and financial policy where the government adopted policies that were consistent with the anti-statist tenets of liberalism. On balance, however, it is clear that, in both cases, the presence and activity of the state expanded considerably—and in direct contradiction to what would be expected under a regime committed to adopting liberal reforms.

Financial Policy

In the case of financial policy, financial liberalization began in the early 1980s, as Japanese corporate borrowers increasingly utilized the Euromarket to raise funds and as Japanese banks grew weary of purchasing government bonds below market rates without the ability to resell them in the secondary market.¹⁴ In the following decade, amid mounting concerns that the Tokyo

financial market would increasingly lose market shares to other international financial centers, the Hashimoto cabinet promulgated the “Japanese Big Bang.” With the aim of making the Tokyo financial market comparable in scale to those of London and New York, the five-year plan, launched in November 1996, called for sweeping financial reforms that would transform Japan’s financial market into one that was “free, fair, and global.”¹⁵

Admittedly, these changes are consistent with the neoliberal claim that greater capital mobility prompts state regulators to embrace financial liberalization. These changes, however, at best offer only an incomplete, if not distorted, picture of how the relationship between the state and the market has unfolded in Japan during the 1990s. For example, one insightful comparative study, which includes the case of Japan up to the mid-1990s, reveals how financial globalization has meant “freer markets” and “more rules”: The Japanese state has opened the financial market to more competition by liberalizing interest rates and commercial activities across financial sectors, but it has also introduced new regulations and reorganized its control of private-sector behavior.¹⁶

The evidence, moreover, becomes even more compelling in the second half of the 1990s, when many financial institutions suffered from high levels of non-performing loans. Greater financial liberalization has been accompanied not simply by “more rules” but also by the creation of several powerful state-backed institutions entrusted with substantial financial resources and a wide range of regulatory authority that surpasses what are deemed “prudential regulatory” safeguards. Under such conditions, the state can adopt any of a number of options:

- (1) do nothing and let the market sort out the winners and losers (or let the market sort out winners and losers in conjunction with enforcing prudential regulations such as stricter accounting and disclosure rules, capital adequacy, etc.);
- (2) ensure at a minimum the ability of depositors to withdraw their funds either with taxpayers’ money or from contributions paid in by the lending institutions (presumably for the purposes of reducing the systemic risk of a run on the banks, yet at the risk of creating a moral hazard problem);
- (3) provide public funds to banks to varying degrees for different purposes (i.e., ensure the banks’ solvency, ensure that banks can meet the capital adequacy ratio set by the U.S. Bank for International Settlements, provide enough liquidity so that banks will continue to lend to borrowers in order to keep the economy going);
- (4) nationalize failed private financial institutions (rather than letting them fail as the market sorts out winners and losers); and/or

- (5) adopt the role of private financial institutions and become a significant player in its own right in financial markets.

These options are not mutually exclusive. Rather, they represent, in ascending order, the degree to which the state can play a more active role in the financial market. It is even possible that the state adopt all five options at the same time. To the extent that the state adopts any of the options beyond the first one, however, the further away it becomes from adopting policies that are consistent with a *laissez-faire* position. For instance, if the state's involvement in the financial market is limited to enforcing prudential regulations or acting as an insurer for depositors (i.e., options 1 and 2, respectively), one can reasonably make the claim that the state is simply increasing transparency and trust so that the market mechanism can operate more efficiently. In contrast, if the state subsidizes, nationalizes, or takes on the role of private financial institutions (options 3, 4, and 5, respectively), its level of presence and participation in the market becomes antithetical to a neoliberal regime and more consistent with that of an East Asian developmental state model.¹⁷

What is striking in the case of Japan is that, despite the growing rhetorical commitment to adopting liberal financial reforms from the second half of the 1990s onward, the state in fact exercised more extensively options 3–5 than during previous years. For instance, the extent to which the state adopted the role of private financial institutions in terms of both providing loans and collecting savings deposits increased significantly since 1989. Although private financial institutions faced fewer market restrictions in terms of the financial commodities and services they could offer, private banks retrenched and reduced their volume of lending throughout the 1990s. Consequently, the state filled in the gap, providing both loans and credit guarantees primarily, though not exclusively, through the Fiscal Investment and Loan Program (FILP).¹⁸ As illustrated in table 1, public sector lending in 1989 amounted to ¥278 trillion, or 22.3 percent of total lending. Ten years later, public sector lending climbed to ¥553 trillion, representing 35.4 percent of total lending.

The state's role in the deposit-taking side is equally telling. Despite the fact that financial liberalization allowed commercial banks to offer depositors more competitive rates, the state-run postal savings system continued to play a prominent role in taking in deposits throughout the 1990s. Indeed, postal savings deposits increased significantly during this period as depositors lost confidence in private banks, given the banks' large accumulation of non-performing loans. As seen in table 2, total deposits in postal savings were already quite high in 1989, amounting to ¥135 trillion, or 15.2 percent of total deposits. In ten years' time, postal savings deposits almost doubled in real terms, totaling nearly ¥262 trillion by 1999. The irony here is that, despite the repudiation of the developmental model, the state was increasingly

TABLE 1 Public Sector Lending as a Percentage of Total Loans

Year	Total Loans	Loans by Public Sector	% of Total Loans
1989	12,462,307	2,783,583	22.34
1990	13,281,081	3,029,823	22.81
1991	13,829,940	3,293,929	23.82
1992	14,279,510	3,606,892	25.26
1993	14,548,020	4,035,608	27.74
1994	14,788,899	4,432,990	29.98
1995	15,207,314	4,591,725	30.19
1996	15,262,123	4,867,451	31.89
1997	16,211,710	5,079,253	31.33
1998	15,830,802	5,281,621	33.36
1999	15,612,060	5,529,142	35.42
2000	15,728,689	5,535,660	35.19
2001	15,066,044	5,372,353	35.66
2002	14,533,678	5,168,915	35.57

NOTE: Amounts are in ¥100 million. All figures from “stock” (Financial Assets and Liabilities) tables for the fiscal years indicated; flow of funds data, Bank of Japan. Total loans taken from intersection of assets shown in “financial institutions” sector and row indicating “loans” (row C). Loans by public finance taken from intersection of assets shown in “financial institutions” sector and row indicating “loans by public financial institutions” (row Ce). Available online at <http://www.boj.or.jp/en/theme/research/stat/sj/> (accessed July 12, 2007).

relying on one of the model’s chief institutions (i.e., FILP) to raise the level of public-sector lending and deposit-taking.¹⁹

Another example of how the state’s role expanded during this period can be seen by how the state dealt with private financial institutions. While Economic Minister Heizō Takenaka succinctly summarized the neoliberal position when he stated that “no bank was too big to fail,” the state did not simply let market forces winnow out weak financial institutions.²⁰ Instead, when many banks and other financial institutions recorded high levels of non-performing loans in 1998, the Diet passed a package of bills that provided roughly ¥60 trillion (12 percent of nominal GDP) of public funds to be supervised by a newly created Financial Reconstruction Commission (FRC, *Kin’yū Saisei Inkai* 金融再生委員会). The new law gave the FRC the mandate to protect depositors of failed banks, recover bad loans, liquidate and temporarily nationalize failed banks, and strengthen the capital-adequacy ratio of solvent banks.²¹ With these new laws in place, the government took immediate action, nationalizing two major banks (Long-Term

TABLE 2 Postal Savings Deposits as a Percentage of Total Deposits

Year	Total Deposits	Postal Savings Deposits	% of Total Deposits
1989	8,869,442	1,350,876	15.23
1990	9,135,078	1,366,391	14.96
1991	9,424,026	1,559,939	16.55
1992	9,656,511	1,709,971	17.71
1993	9,989,764	1,844,519	18.46
1994	10,246,516	1,985,509	19.38
1995	10,621,183	2,140,276	20.15
1996	10,843,232	2,262,506	20.87
1997	11,141,090	2,419,668	21.72
1998	11,342,902	2,541,769	22.41
1999	11,842,778	2,616,989	22.10
2000	11,928,225	2,512,333	21.06
2001	12,186,355	2,411,949	19.79
2002	12,279,025	2,377,006	19.36

NOTE: Amounts are in ¥100 million. All figures from “stock” (Financial Assets and Liabilities) tables for the fiscal years indicated; flow of funds data, Bank of Japan. Total deposits taken from intersection of liabilities shown in “depository corporations” sector and row indicating “currency and deposits” (row A). Deposits held in postal savings accounts taken from intersection of liabilities shown in “postal savings” sector and row indicating “currency and deposits” (row A). Available online at <http://www.boj.or.jp/en/theme/research/stat/sj/> (accessed July 12, 2007).

Credit Bank and Nippon Credit Bank) and injecting ¥7.7 trillion of public funds into the banking system, primarily by purchasing the banks’ preferred stock or bonds. Over time, as the government continued to inject public funds into commercial banks, the state, in essence, purchased a significant share of the stock ownership of private banks in exchange for the banks’ ability to continue conducting business.²²

In sum, these measures not only refute the simple notion of a regulatory race to the bottom but also go well beyond the state renewing its authority in the form of creating and enforcing prudential regulations so that the market mechanism can operate with greater efficiency and transparency. Instead, in the case of Japan, financial liberalization has been accompanied by active Diet deliberations that culminated in the creation of new public institutions with substantial financial resources and regulatory powers. Although measures such as the Big Bang were indeed significant in liberalizing the Japanese financial market, the government also became a more direct and active participant in the financial market by staking out an ownership position in all

the major banks, temporarily nationalizing major banks, and expanding its role as both a lending and deposit-taking institution.

Macroeconomic Policy

Macroeconomic policy presents a similar pattern. At first glance, macroeconomic policymaking in Japan appears to be consistent with the neoliberal claim that posits a shift from Keynesianism to monetarism. The administrative and fiscal reform movement that was headed by Rinchō 臨調 (short for *Dai Niji Rinji Gyōsei Chōsakai* 第二次臨時行政調査会, the Second Provisional Commission on Administrative Reform) and launched in the early 1980s explicitly rejected the heavy use of Keynesian deficit spending that was the hallmark of the 1970s. Instead, its main objective was to pursue “fiscal reconstruction without tax increases” (*zōzei naki zaisei saiken* 増税無き財政再建) and eliminate the issuance of deficit-financing bonds by 1990.

Upon close scrutiny, however, it is clear that, while the government was indeed able to meet its target by 1990, the measures that were adopted to achieve this goal strayed widely from Rinchō’s basic tenet. Whereas Rinchō sought to eliminate deficit financing through cuts in government expenditures, over 80 percent of the deficit reduction was in fact attributable to either higher-than-projected increases in tax revenues or to having shifted government expenditures out of the main budget (General Account Budget) to other government accounts.²³ Moreover, any pretense of repudiating Keynesian fiscal policy was abandoned throughout most of the 1990s, as the government adopted a series of pump-priming measures in the face of Japan’s worst economic recession in decades. As table 3 illustrates, the Japanese government adopted nine sizeable economic stimulus packages between August 1992 and October 2000, totaling ¥129 trillion.

To be sure, suggesting that there was no evidence that the government adopted a neoliberal stance with respect to macroeconomic policy during this period would be inaccurate. In fact, in 1997, the Hashimoto administration adopted a stringent budget for fiscal year 1997 and phased in a scheduled consumption tax increase from 3 to 5 percent in an effort to reduce the sizeable budget deficit incurred in the first half of the decade. Moreover, in November 1997, the Hashimoto administration enacted the Fiscal Reform Law, which called for the elimination of deficit-finance bonds by the end of fiscal year 2003 and the reduction of the combined budget deficit of national and local governments to 3 percent or less of GDP.²⁴

These measures adopted by the Hashimoto administration, however, are the exceptions that prove the rule. Not even one year after the Fiscal Reform Law was enacted, the government was forced to reverse course. After posting a real GDP growth of 1.5 percent in 1995 and 3.9 percent in 1996, the economy slid back into a serious recession, in no small part as a result of the contractionary impact of the Hashimoto administration’s mac-

TABLE 3 Fiscal Stimulus Packages, 1992-2000

Date	Amount	Percent of GDP
August 28, 1992	10.7	2.3
April 13, 1993	13.2	2.8
September 16, 1993	6.0	1.3
February 8, 1994	15.3	3.2
[April 14, 1995] ^a	[7.0]	[1.4]
September 20, 1995	14.2	3.0
April 24, 1998	16.7	3.4
November 16, 1998	23.9	4.9
November 11, 1999	18.0	3.5
October 19, 2000	11.0	2.1
<i>Total</i>	129.0	—

SOURCE: *OECD Economic Surveys: Japan* (Paris: OECD, 2000): 53.

NOTE: Amounts are in trillions of yen.

^aThe April 1995 package was excluded from the total figure because these allocations were primarily for Kobe earthquake relief rather than for economic stimulus.

roeconomic policy.²⁵ Consequently, the government unveiled a new stimulus package in April 1998 worth over ¥16 trillion. Seven months later, with no recovery in sight, the government announced an even bigger stimulus package, worth ¥24 trillion. With this package, the government suspended the Fiscal Reform Law, as the bond–dependence ratio soared to a record high 38.6 percent. In November 1999, the Obuchi administration launched a new pump-priming package worth ¥18 trillion in the face of a 1 percent decline in the economy during the July–September period from the previous quarter.²⁶ By 1999, the cumulative effects of these economic packages, together with the decline in tax revenues caused by the poor performance of the economy, had raised the General Account Budget’s dependence on debt to 43.4 percent of the total budget, a level even higher than that recorded during Japan’s fiscal crisis of the late 1970s.²⁷

Given the inability of neoliberals to predict Japanese macroeconomic policy outcomes during this period, the fallback position has been to argue that Japan’s use of Keynesian policy was ineffective and mistaken, producing an unsustainable level of government debt that has weakened the economy and imposed huge tax burdens on future generations.²⁸ But, here again, it is important to separate the neoliberal myth from reality.

Although it is true that the total amount of government debt rose dramatically, at least half of this increase is attributable to the fall in tax revenues caused by the weak economy.²⁹ Moreover, contrary to neoliberal expectations, fiscal expansion had not produced inflation, and high levels of government debt did not “crowd out” potential private borrowers by raising interest rates. Indeed, the chief problem throughout this period was deflation, not inflation; and interest rates remained low.

Additionally, the hidden hand of the state has played a prominent role in managing the government bond market. While neoliberal observers are quick to point out the extensive amount of deficit-financing bonds the government has issued in its effort to cover the shortfall between tax revenues and public expenditures, what often goes unmentioned is the extensive role the state plays in purchasing the debt that it creates. As seen in table 4, over half the total amount of government bonds outstanding is currently held by the state itself, with the lion’s share in the hands of the Trust Fund Bureau (a bureau within the Ministry of Finance) and the Bank of Japan.³⁰

TABLE 4 Public Sector Share of Total Japanese Government Bonds (JGB) Purchased

Year	Total JGB	Public Sector Purchase of JGB	Public Sector %
1993	2,037,000	947,205	46.50
1994	2,191,000	988,141	45.10
1995	2,417,000	1,148,075	47.50
1996	2,709,000	1,311,156	48.40
1997	2,997,000	1,513,485	50.50
1998	3,391,000	1,780,275	52.50
1999	3,667,000	1,903,173	51.90
2000	4,090,000	1,918,210	46.96
2001	4,692,000	2,618,136	55.80
2002	5,368,000	3,059,760	57.00
2003	5,699,346	3,197,921	56.11
2004	6,424,655	3,618,054	56.32
2005	6,718,823	3,745,183	55.74

SOURCE: Japanese Ministry of Finance, http://www.mof.go.jp/jouhou/kokusai/jgb_guidebook2006j.pdf; http://www.mof.go.jp/singikai/saimukanri/tosin/ksk151125_s.pdf.

NOTE: “Public sector” includes the General Government and Central Bank.

In short, these trends clearly refute the argument about the globalization of the international capital market and its impact on macroeconomic policy. Greater capital mobility in Japan during the 1990s did not force the government to repudiate Keynesian fiscal policy in favor of monetarist orthodoxy. Instead, the government, throughout most of that decade, adopted a series of fiscal stimulus measures at a time when economic growth, and, hence, tax revenues, remained stagnant. Moreover, while these combined factors produced—by the end of the decade—a gaping fiscal deficit higher than that of any other G-7 advanced industrial democracy, it did not create inflationary pressures or lead to higher interest rates, as neoliberals predicted. Instead, the sharp rise in government debt was managed along lines consistent with the general argument presented in this article, namely, through the hidden but active hand of the state.

New Perspectives on Causes & Consequences of Japan's Economic Malaise

As noted at the outset of this article, neoliberal arguments and assumptions have informed not only the prevailing interpretation of why Japan's economy has stagnated since the early 1990s but also the necessary course of action the government would need to adopt in order for the economy to recover. According to this perspective, the cause of Japan's economic malaise is the continued legacy of a strong and activist state inherited from Japan's developmental model. The cure is to conduct structural reform and scale back the state so that the market can make more efficient decisions about how scarce resources are allocated.

In this article, I draw very different conclusions about both the causes and consequences of Japan's prolonged period of economic stagnation. Although I acknowledge that the legacy of Japan's developmental model may have exacerbated the economic problem, it did not cause it. Moreover, while the government has embraced a commitment to neoliberal reforms since the early 1990s, the actual policies they have adopted have strengthened the role of the state. To the extent, therefore, that the Japanese economy has shown signs of a sustained (though modest) level of economic growth in recent years, the notion that this turnaround is attributable to the adoption of *laissez-faire* policies is highly suspect for several reasons.

First, with respect to the cause of Japan's long period of economic stagnation, there is a strong consensus that the starting point of Japan's economic downturn can be traced to the collapse of the speculative bubble in the stock and real estate markets in early 1990. The question, however, is what key underlying conditions created the bubble. I argue that speculative booms followed by economic collapse are a recurrent theme of free-market economies. The liberalization of highly regulated financial markets may

indeed reduce market distortions and provide greater opportunities for banks to make loans, as neoliberal proponents stress. But these can include bad or risky loans that produce a speculative bubble or a crisis of confidence in bank solvency.³¹ When financial markets are flourishing, greed—mixed with the general uncertainty of the stock market—stretches what may be deemed plausible or rational.³² In the case of Japan in the second half of the 1980s, as in the case of the United States in the second half of the 1990s, numerous economic commentators on both sides of the Pacific argued that the sharp rise in the stock markets was sustainable.³³ Under these conditions, investors do not simply purchase stocks based on the price-earnings ratio but, rather, on the expectation of what other investors will do—and how their actions will influence future stock prices. Accordingly, sharp rises in the stock market can be fueled by a self-fulfilling prophecy that invariably produces an unsustainable asset bubble.

In this light, Japan's bubble economy of the 1980s and its collapse in the early 1990s is merely one example out of many of a speculative free market gone awry. Although the South Sea Bubble and the Great Depression are among the most well known historical examples, more recent cases can be readily found. Switzerland, for example, experienced a similar phenomenon during roughly the same period: a bubble in real estate prices burst at the beginning of the 1990s and pushed the economy into a prolonged period of stagnation.³⁴ In Sweden and Finland during the second half of the 1980s, real asset prices (both stock and land prices) also rose at rates comparable to those of Japan and dropped precipitously by the end of the decade. Consequently, these Scandinavian governments also injected huge sums of public funds to dispose of nonperforming assets in the banking sector.³⁵

Perhaps it could be argued that had a more prudential regulatory regime based on neoliberal principles been in place, Japan would not have suffered a prolonged recession. This assumption may be true, but it misses the broader point: A more prudential regulatory regime, by definition, requires the state, or other non-market entities, to regulate and enforce market behavior. More importantly, the existence of such entities will not necessarily prevent the rise and bursting of a speculative bubble.³⁶ Although the United States is often held as the model of a liberalized financial market with prudential regulatory safeguards, such safeguards have clearly failed to prevent serious financial crises. Putting aside the Savings and Loan crisis, Black Monday (October 19, 1987), or the more recent corporate scandals involving Enron, WorldCom, and others, the sharp downturn in the stock market that began in March 2000 illustrates a classic example of a financial bubble that has burst. Moreover, it is only after the bubble bursts that the folly of "irrational exuberance" is met with sober recognition. In a telling remark paralleling remarks made by Newton in 1720, Federal Reserve Chairman Alan Greenspan acknowledged that, because of human psychology,

“bubbles tend to feed on themselves,” but it is “very difficult to definitely identify a bubble until after the fact—that is, when its bursting confirmed its existence.”³⁷ In short, developmental states are not the only economies to suffer from speculative booms followed by economic collapse; such phenomena occur in all varieties of market-based economies.³⁸

This article also draws very different conclusions about the economic and political consequences of Japan’s prolonged period of economic stagnation. If, as I argue, the rise and collapse of the bubble economy was not caused by Japan’s domestic political and economic institutions themselves but rather by the neoliberal, free-market strategy that the LDP adopted in the 1980s (i.e., a more liberalized financial market and the rejection of Keynesianism over monetarism), it seems implausible that the Japanese government would adopt the same strategy to work its way out of economic malaise. Indeed, as the evidence indicates, the LDP, despite its continued rhetorical adherence to a neoliberal paradigm, expanded—rather than eroded—the role of the state throughout the 1990s. This situation occurred not simply because the number of claimants seeking compensation from the government increased. This explanation certainly accounts for part of the story. But on a more fundamental level, the market itself needed the state to assume a greater role in order to remedy the economic instability created by the market itself under a monetarist strategy where cheap credit was abundant and mobile.

Informed by neoliberal principles, LDP leaders, such as former prime minister Koizumi, repeatedly stressed the importance of scaling back the state and giving the market a correspondingly greater role in making allocative decisions that were hitherto made through democratic deliberations. To be sure, an excessive reliance on the state to make allocative or regulatory decisions based on social and political considerations may indeed create market inefficiencies, or generate a fiscal crisis, as neoliberal proponents insist. However, it is equally plausible that an unfettered market can create its own form of crisis that compels the state to assume a greater role in the market. Viewed accordingly, the rise of neoliberalism as a dominant paradigm becomes doubly suspect when placed in the Japanese context because it not only obscures the extensive role that the state has played in both fostering and sustaining market-friendly reforms but also reduces the sphere of democratic choice on issues that seek to reduce the social costs of economic dislocation that a liberalized market can create.

Notes

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¹For Newton's quotation, as well as the circumstances surrounding it, see J. Carswell, *The South Sea Bubble* (London: Cresset Press, 1960), 108.

²Ibid.

³Details of Newton's work can be found on the British Royal Mint's Web site: http://www.royalmint.com/RoyalMint/web/site/Corporate/Corp_museum/isaacnewton.asp (accessed July 13, 2007).

⁴For a contemporary example, see Michael Bell, "Globalization: Threat or Opportunity?" *International Monetary Fund Issue Brief*, April 12, 2000. For the classic text, see Milton Friedman, *Capitalism and Freedom* (Chicago: University of Chicago Press, 1962).

⁵The outspoken proponent of this position is Jürgen Habermas, who notes: "The trends summed up in the word 'globalization' are not only jeopardizing, internally, the comparative homogenous make-up of national populations—the pre-political basis for the integration of citizens into the nation-state—by prompting immigration and cultural stratification; even more tellingly, a state that is increasingly entangled in the interdependencies between the global economy and global society is seeing its autonomy, capacity for action, and democratic substance diminish." Jürgen Habermas, "The European Nation-State and the Pressures of Globalization," *New Left Review* 1, no. 235 (1999): 46–59, 48.

⁶The definitive study is Chalmers Johnson, *MITI and the Japanese Miracle: The Growth of Industrial Policy, 1925–1975* (Stanford, CA: Stanford University Press, 1982). For a comparatively informed study of the East Asian developmental model, see Peter Evans, "Predatory, Developmental, and Other Approaches," *Sociological Forum* 4, no. 4 (1989): 561–87.

⁷For an in-depth analysis of Nakasone's platform, see Hideo Otake, "Nakasone seiji no ideogōji to sono kokunai seijiteki haikai" 中曽根政治のイデオロギーとその国内政治的背景 [The ideology of Nakasone's politics and its domestic political background], *Revaiasan* レヴァイアサン [Leviathan] 1 (fall 1987): 73–91.

⁸Prime Minister Koizumi (in office 2001–7) was a chief proponent of this view. In his opening statement at a press conference on April 27, 2001, he noted: "without structural reforms there can be no economic recovery. . . . For such reforms I believe that it will be necessary to return to the drawing board, and start from zero. . . . We should also see to it that of the various activities that the state has performed in the past, all that can be accomplished by the private sector should be left in its hands." A translation of his speech is available on the Japanese Cabinet Web site: http://www.kantei.go.jp/foreign/koizumispeech/2001/0427pressconference_e.html (accessed July 13, 2007).

⁹Polanyi explains: "The road to the free market was opened and kept open by an enormous increase in continuous, centrally organized and controlled intervention. . . . Thus even those who wished most ardently to free the state from all the unnecessary duties, and whose whole philosophy demanded the restriction of state activities, could not but entrust the self-same state with the new powers, organs, and instruments required for the establishment of laissez-faire." Karl Polanyi, *The Great Transformation* (Boston: Beacon Press, 1957), 140–41.

¹⁰For example, the notion of property rights that are exclusive and private took place in England through Parliamentary acts of enclosure. Other examples include the notion of money that is backed by the state as "legal tender" and the state's enforcement of contracts. The classic work on the enclosures is Barrington Moore, *Social Origins of Dictatorship and Democracy: Lord and Peasant in the Making of the Modern World* (Boston: Beacon Press, 1966). On the state's role in enforcing contracts, see Barry R. Weingast, "Constitutions as Governance Structures: The Political Foundations of Secure Markets," *Journal of Institutional and Theoretical Economics* 149, no. 1 (1993): 286–311.

¹¹On a more formalized level, scholars have built on the Mundell–Fleming model to illustrate how fiscal policy loses its effectiveness under conditions of capital mobility and flexible exchange rates, as greater fiscal spending generates upward pressures on both interest rates and the exchange rate. For an excellent review of this literature, see Benjamin J. Cohen, “Phoenix Risen: The Resurrection of Global Finance,” *World Politics* 48, no. 2 (1996): 268–96.

¹²For a succinct argument, see Philip G. Cerny, “International Finance and the Erosion of State Policy Capacity,” in *Globalization and Public Policy*, ed. Philip Gummet (Cheltenham, England: Edward Elgar, 1996), 83–104.

¹³On this point, see Henry Laurence, *Money Rules: The New Politics of Finance in Britain and Japan* (Ithaca, NY: Cornell University Press, 2001); and Sebastian Mallaby, “In Asia’s Mirror: From Commodore Perry to the IMF,” *National Interest* 52 (summer 1998): 13–21.

¹⁴For good overviews, see Frances Rosenbluth, *Financial Politics in Contemporary Japan* (Ithaca, NY: Cornell University Press, 1989); and James Horne, *Japan’s Financial Markets: Conflict and Consensus in Policymaking* (Sydney: Allen & Unwin, 1985).

¹⁵Robert Dekle, “The Japanese Big Bang: Financial Reforms and Market Implications,” *Journal of Asian Economics* 9, no. 2 (1998): 237–49. For the official government statement outlining the content of the Big Bang, see <http://www.mof.go.jp/english/big-bang/ebb37.htm> (accessed July 13, 2007).

¹⁶Steven K. Vogel, *Freer Markets, More Rules: Regulatory Reform in Advanced Industrial Countries* (Ithaca, NY: Cornell University Press, 1996).

¹⁷For an in-depth analysis of the how the East Asian model’s financial policy differs from the liberal model, see Joseph E. Stiglitz and Marylou Uy, “Financial Markets, Public Policy, and the East Asian Miracle,” *World Bank Research Observer* 11, no. 2 (1996): 249–76.

¹⁸In addition to the public financial corporations that formed the core of FILP lending activities, even the Bank of Japan (BOJ) became involved, purchasing commercial papers from corporations unable to raise funds from private financial institutions. (Commercial papers are negotiable, short-term, unsecured promissory notes issued in bearer form, usually on a discount basis, by a corporation to raise working capital for any term normally up to 180 days.) By the end of September 1998, the BOJ had purchased ¥5.6 trillion worth of commercial papers, or 39.4 percent of the total outstanding. Figures are from Douglas Ostrom, “Central Banks Adjust Monetary Policy to Global Turmoil,” *JEI Report* 40 (October 23, 1998): 1.

¹⁹For an in-depth treatment of the role of FILP in Japan’s developmental model, see Johnson, *MITI and the Japanese Miracle*.

²⁰Takenaka’s quotation was reported in George Wehrfritz and Kideko Takayama, “No Bank Is Too Big to Fail,” *Newsweek* (October 14, 2002): 46.

²¹The two major bills passed were the “Law Concerning Emergency Measures for the Reconstruction of the Functions of the Financial System” and the “Financial Function Early Strengthening Law.” Funds were allocated as follows: ¥17 trillion for refunding depositors of failed banks, ¥18 trillion for state-run bridge banks or other forms of public control, and ¥25 trillion for capital injection into solvent banks.

²²By 2005, the amount of public funds used to stabilize the financial system totaled ¥35.8 trillion. Kazuhito Ikee and Yasuo Goto, “The Government and the Financial System: An Overview,” *Public Policy Review* 2, no. 1 (2006): 97–139, 106.

²³For a detailed account, see Takaaki Suzuki, “Administrative Reform and the Politics of Budgetary Retrenchment in Japan,” *Social Science Japan Journal* 2, no. 2 (1999): 195–213.

²⁴International Monetary Fund, *World Economic Outlook: Financial Turbulence and the World Economy* (Washington, DC: International Monetary Fund, October 1998), 116–17. Available online at <http://www.imf.org/external/pubs/ft/weo/weo1098>.

²⁵In fact, some experts argue that Hashimoto's macroeconomic policy was a major policy blunder that hindered the recovery under way. See, for example, Takatoshi Ito and Hugh Patrick, "Problems and Prescriptions for the Japanese Economy," in *Revising Japan's Economy*, ed. Takatoshi Ito, Hugh Patrick, and David E. Weinstein (Cambridge, MA: MIT Press, 2005), 1–36: 16.

²⁶The April 1998 package was reported by Jiji Press Ticker Service (April 24, 1998); the ¥24 trillion package, in *Japan Weekly Monitor* (November 30, 1998); and the November 1999 measure, in *Japan Economic Newswire* (December 9, 1999).

²⁷Ministry of Finance, *The Budget in Brief* (Tokyo: Budget Bureau, Ministry of Finance, 2000), 2.

²⁸Milton Friedman, the godfather of economic neoliberalism, put it succinctly, stating that the result of Japan's use of fiscal policy during this period was "stagnation at best, depression at worst." Milton Friedman, "No More Economic Stimulus Needed," *Wall Street Journal*, October 10, 2001.

²⁹General government tax revenues fell from a peak of 22.50 percent of GDP in FY 1990 to 18.25 percent in FY 1994, of which the bulk of the decline was due to a fall in tax elasticities, particularly the impact of declining profitability on corporate tax receipts. For figures, see International Monetary Fund, *World Economic Outlook: Fiscal Policy and Macroeconomic Stability* (Washington, DC: International Monetary Fund, May 2001), 90–92. Available online at <http://www.imf.org/external/pubs/ft/weo/2001/01/index.htm>.

³⁰At the end of FY 1999, the total amount of outstanding government bonds held by financial institutions was ¥360.6 trillion, of which ¥187.3 trillion were held by the public sector. The Trust Fund Bureau held ¥79.9 trillion, while the BOJ held ¥49.8 trillion. Figures taken from BOJ (Research and Statistics Department), "Japan's Financial Structure: In View of the Flow of Funds Accounts" (December 28, 2000), chart 15.

³¹This point is made most cogently by Charles Kindleberger, *Manias, Panics, and Crashes: A History of Financial Crises* (New York: Basic Books, 1978). For a more formalized model of systemic risk, see Mico Loretan, "Economic Models of Systemic Risk in Financial Systems," *North American Journal of Economics and Finance* 7, no. 2 (1996): 147–52.

³²As Hugh Patrick notes: "What the Japanese 'bubble' economy of the late 1980s and early 1990s experience demonstrates is that even strong systems and institutions, not only banks but their regulators, can fall prey to collective myopia, and that greed in periods of speculative mania can outweigh rational conservative calculation of project viability, borrower credit-worthiness, and collateral value." Hugh Patrick, "The Relevance of Japanese Finance and Its Main Bank System," *The Japanese Main Bank System: Its Relevance for Developing and Transforming Economies*, ed. Masahiko Aoki and Hugh Patrick (New York: Oxford University Press, 1994), 353–409: 406.

³³In the case of the United States, popular books were published as late as 1999 suggesting that the Dow Jones Industrial Average would reach anywhere from 36,000 to 100,000. See, for example, David Elias, *Dow 40,000: Strategies for Profiting from the Greatest Bull Market in History* (New York: McGraw-Hill, 1999); and Charles W. Kadlec, *Dow 100,000: Fact or Fiction* (New York: New York Institute of Finance, 1999).

³⁴George Rich, "Comment," *Monetary and Economic Studies* (February 2001): 104–5.

³⁵The public funds used for this purpose amounted to 4.7 percent of nominal GDP in the case of Sweden (1991–93) and 7.3 percent in the case of Finland (1991–92). Kunio

Okina, Masaaki Shirakawa, and Shigenori Shiratsuka, "The Asset Price Bubble and Monetary Policy: Japan's Experience in the Late 1980s and the Lessons," *Monetary and Economic Studies* (February 2001): 395–450, 404–5.

³⁶More transparent bank disclosures and stricter accounting standards would not necessarily have revealed fraudulent banking practices during this period, given the asset inflation that presumably served to balance banks' ledger sheets. That is, high yields in the stock and real estate markets during the speculative bubble phase would have minimized the level of banks' non-performing loans. Such is true especially under the prudential regulatory guideline that calls for accounting practices based on the present book values of stocks rather than on original purchasing values.

³⁷Greenspan's remark was reported in David Stout, "Greenspan Says Fed Could Not Prevent Market Bubble," *New York Times*, August 30, 2002.

³⁸The key distinction in the "varieties of capitalism" literature I reference is between the "liberal" and the "coordinated" market economies, with the United States and Great Britain representing the former, and the continental European "social model" and Japan representing the latter. For a good overview, see Peter A. Hall and David Soskice, eds., *Varieties of Capitalism: The Institutional Foundations of Comparative Advantage* (Oxford: Oxford University Press, 2001).