State capacity in Japan's economy and its impact on Japan's economic status in East Asia 1945-2000

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Abstract

In postwar economic development, Japan has chosen a different way to neoliberalism. The government did not "step back" from the market or rely on the action of the "invisible hand"; it played an important role itself in economic development. Under the guidance and intervention of the state, Japan became an economic miracle and the most successful industrialized economy in the world, then experienced a collapse followed by great stagnation. Simultaneously, while Japan used to have the role of driver and leader of the regional economy before the collapse, it lost its advantageous position when it became stuck in great stagnation. Japan's economic status changed drastically accompanied with its changing economic power. For an economy like Japan that cooperated highly with the state, the capacity of the state would have a huge impact on the economy, on both economic power and economic status. Japan's changing economic power and status in the region became a

mirror to reflect the changing state capacity in Japan.

Key words: state capacity; Japanese government; economic development; flying geese pattern; bubble economy; East Asia

Abbreviation

ADB: Asian Development Bank

ASEAN: Association of Southeast Asian Nations

BOJ: Bank of Japan

CME: Coordinated market economy

FDI: Foreign direct investment

GATT: General Agreement on Tariff and Trade

JETRO: Japanese External Trade Organization

JMN: Japanese Multinational corporation

LDP: Liberal Democratic Party

MITI: Ministry of International Trade and Industry

MNC: Multinational corporation

MOF: Ministry of Finance

NIE: New Industrial Economy

NPL: Nonperformance loan

ODA: Overseas development assistance

OECD: Organization for Economic Co-operation and Development

TASF: Technical Assistance Special Fund

VLSI: Very Large Scale Integration

Content

Introduction

In 2009, the GNI per capita of Singapore almost reached Japan's for the first time. In 2011, China's GDP surpassed Japan's and Japan dropped from the second largest economy in the world to third simultaneously losing its top position in the region. Nowadays, with the development of regionalization, Japan in the East Asian economy seems like a normal member in this dynamic region. But how many people can still remember that Japan used to be the biggest economy in the world in the 80s, while Singapore was only one of the NIEs, which relied on Japan's capital and techniques, and China fell behind even Singapore? At that time, Japan was a key element driving the development of the regional economy. Japan's postwar development was a miracle shocked the world, as Johnson has noted,

> "The late development, a lack of natural resources, a large population, the need to trade, and the constraints of the international balance of payments still exist in Japan today, but they have been mitigated by overseas investment, trade surpluses, diversification of markets, and so forth."[1]

It seems like the crash of Japan's golden age was overnight; what replaced Japan's prosperity was a severe recession, as the whole world continued forward. Vogel says that Japan astonished the world twice: the first time was the postwar Japanese miracle, the second time was collapse of the bubble economy in the

1 Chalmers Johnson, *MITI and the Japanese miracle: the growth of industrial policy: 1925-1975.*(Stanford University Press, 1982), 307

beginning of 1990s and the following ten-year stagnation.[2] In reality, the stagnation has lasted much longer than one decade, since the year 2000 till now, Japan has experienced economic downturn 3 times in the last 17 years. It is not easy to say that Japan has recovered, especially when one compares it with the other booming regional economies such as China. There are still many arguments around whether China is leading, but the belif that "Japan is not leading the region anymore" seems to be a consensus. Macintyre and Naughton believe that Japan has shifted its relative position with China's, which is the most important change in East Asia since the 90s.[3] Although the recent measures that Japan took to recover its economy such as the Koizumi's privatization and Abenomics, the most impressive marks of Japan are still the postwar Japanese miracle and the "lost decade" which started with the burst of the bubble economy.

Further to the drastic rise and fall of the Japanese economy, the Japanese developing mode has been very distinctive from the Anglo-American style. In this mode, the market did not act as the invisible hand to promote the economy or allocate resources; on the contrary, the government did. Since Japan and Japan's imitators (East Asian Economies) have made great economic achievements in this mode, this state-led mode has generated a wide discussion and a series of interesting questions. If the Japanese state has the power to lead the economy, then why did success only come to Japan and not to some other controlled economies that enjoy more centralized power, or some socialist economies? If the Japanese state did lead the economy to success, then why did it fail in the 1990s? Some scholars try to answer these questions from the perspective of the intervention quality, examining if the state has the ability to intervene in the economy successfully.[4] Weiss gives the concept of state capacity and believes that states with strong state capacity are not the states with centralized power but the states that can cooperate with social sectors, arguing Japan is an archetypal "strong state". But this begs the question of how to define and measure

2 Steven K Vogel, *Japan Remodeled: how government and industry are reforming Japanese capitalism.*(Ithaca, N.Y. etc.: Cornell University Press, 2006), 22

3 Andrew Macintyreand Barry Naughton, "The Decline of a Japan-Led Model of East Asian Economy", in *Remapping East Asia: the construction of a region*, ed. T.J. Pempel (Ithaca and London: Cornell University Press, 2005), 88

4 Anil Khosla, "State and Economy: Some Observations and Inferences from the Japan Experience", in *State Capacity in East Asia: Japan, Taiwan, China, and Vietnam*, ed. Kjeld Erik Brødsgaard and Susan Young.(Oxford: Oxford University Press, 2000), 42

state capacity. And also what the impact of strong/weak state capacity to the economy is, especially in a gradually globalizing world?

With this in mind, this thesis would focus on the changeability of state capacity in Japan, the connection between state capacity and Japan's economy, and its impact on Japan's regional economic status. Firstly, chapter one is the literature review, containing the previous studies and illustrations of the state capacity theory. The previous research into the Japanese economic mode and the method of this thesis will also be discussed in this chapter. Then state capacity in Japan before the collapse will be studied in chapter 2, as well as its impact on Japan's economy and economic status in the region. Furthermore, chapter 3 includes the performance of state capacity after the collapse till 2000, and its connection with the collapse and the changes of Japan's economic status. At the end the conclusion of this thesis would be drawn. In addition to this, considering the Japanese government has experienced frequent political alternation and several "reforms", the complicated and uncertain political and economic conditions in Japan, the study will focus on the postwar period to 2000.

Chapter 1. Literature Review: State capacity and Japan

1.1 The state capacity theory study

The state capacity theory was formed in the 1960s and has evolved over time. As the name implies, the state capacity theory mainly emphasizes the role of the state. Given the postwar socio-economic conditions and the success of Keynesianism, theories which were centered on the role of the state also prevailed. Skocpol was the pioneer of the first generation of the state capacity theory, which came with her state autonomy theory, in her book *States and Social Revolutions.* With the inefficient response of states in the capitalist world oil crisis in the 1970s, and the trend of globalization and trade liberalization in the 1980s, theories about state declined while neoliberalism regained dominance. The role of the state in the capitalist world was weakened by market. However, it was also in the 1980s, when neoliberalism was prevailing, that many scholars began to reconsider the role of the state, including its capacity. The publication of the book, *Bring The State Back* by Evans, Rueschemeyer and Skocpol, brought the state-centered research trend back. Among the available studies, despite the fact that many scholars have contributed to the study of state capacity, there is not a unified and specific definition of state capacity, indicating that the definition is still evolving.

Huang studied the evolving of the conception of state capacity. He classifies the previous studies of state capacity into three categories. The first of the state capacity theories centered in the predominance of the state that rose in the 1960s. Using state autonomy as the starting point and emphasizing the dominant position of the state over society, the theory of state capacity was proposed for the first time.[5] The second wave was the state capacity theory centered on social economic conditions,[6] whilst the third category is mainly based on neorealism and neoliberal institutionalism, emphasizing the state's relative international status.[7] Huang concludes there are two basic aspects of state capacity: the capacity of managing society and the capacity of

5 □□□□□□□□□□□□□□□□□□□□□□□□2007 □ 12 □□25-26[Qingji Huang, The study of the basic theory of state capacity, *Politics Studies* 2007 vol.12, 25-26]

6 Huang, The Study, 28

7 Huang, The Study, 30

facing the challenges and competitions from the other countries.[8]

Like Huang, many scholars also state there is considerable content in the conception of state capacity. Wang and Hu talk about state capacity synthetically, defining it as the capacity of the state to transform its preferences and objectives into reality, including the fiscal extractive capacity, legitimation capacity, and coercive capacity.[9] In the studies of Brødsgaard and Young, the researchers firstly discuss “state” and “capacity” separately then conclude state capacity should include insulated bureaucracy, embedded state-industry networks, and encompassing industrial organization.[10] Cao and Han propose state capacity as a core proposition of political science and an extension of the legitimacy of Weberian state concept,[11] now state capacity is thought to consist of embedded autonomy (from Evans), governed independence (from Weiss), synergy, and governance. Polidano states three elements should be considered in the state capacity: despotic power, policy capacity, and infrastructural power. One distinctive characteristic of these scholars’ studies is that they consider the state capacity from a comprehensive perspective. Nevertheless, some elements are not essential as part of the state capacity theory. For instance, the coercive capacity mentioned by Wang and Hu indicates the ability to maintain stability in the territory and national defense and can be classified as a military ability rather than state capacity since it does not display much of the role of the state of guidance.

Simultaneously, to some other scholars, state capacity is reflected in a state’s achievement. These scholars focus more on the outcome. Painter and Pierre believe state capacity is actually a measure of the state’s ability to mobilize social and economic support and consent for the achievement of publicly regarded goals, focusing on relations between the state and society. They pay more attention to the

8 Huang, The Study, 32

9 [illegible]1993[illegible]22-23[Shaoguang Wang and Angang Hu. A report on China’s State Capacity. Shenyang: Liaoning Publishing House, 1993, 22-23]

10 Kjeld Erik Brødsgaard and Suan Young, *State Capacity in East Asia: Japan, Taiwan, China and Vietnam* (Oxford: Oxford University Press: 2000),19-21

11 [illegible], 2012 [illegible] 38 [illegible]58-59[Haijun Cao and Dongxue Han, The Rise of Statist: The elementary proposition and framework of State Capacity, Sixiang zhanxian 2012 vol.38. 58-59]

achievement of outcomes, as well as the production of policy and administrative outputs.[12] Meanwhile, Matthews also argues that, at the broadest level, the definition of state capacity should be the capacity of creating and maintaining order over a sovereign territory.[13] Actually, it refers more to the capacity of the state to achieve its chosen policy, in the realm of the exercise of power and development of resources.[14] Polidano also gives a more clear definition: state capacity is a state's ability to design and implement policy.[15] Comparatively, taking the achievement of state policy as the core of state capacity sets a more reasonable standard to measure and evaluate the capacity. Without realizing a state's self-interest, it is difficult to evaluate whether a state has a strong state capacity.

Some researchers use "strong state" and "weak state" to discuss the state capacity. In her studies on governance and state capacity, Weiss argues that it is meaningless to generalize the idea of state capacity since the capacities are diverse in different perspectives.[16] In Weiss's opinion, state capacity refers to the ability of policy-making authorities to pursue domestic adjustment strategies in cooperation with organized economic groups, upgrading or transforming the industrial economy, especially in current international competition.[17] Weiss integrates the manifestations of state capacity into five approaches: social bargaining, coercion, policy instruments, embedded autonomy, and infrastructural power.[18] In particular, she takes Peter Evans's embedded autonomy as the distinction of "strong states", emphasizing the relationship between state and social organizations, proposing that strong states with strong state capacity are not the states with the centralization of authority or dictatorship, but are the states that can build good cooperation between social organizations and governmental departments.[19] Khosla shares similar views with Weiss. According to

12 Martin Painter and Jon Pierre, *Challenges to State Policy Capacity: Global Trends and Comparative Perspectives* (Basingstoke etc.: Palgrave Macmillan, 2005), 2
13 Matthews Felicity, "Governance and state capacity" in *The Oxford Handbook of Governance* (Oxford: Oxford University Press, 2012), 281
14 Matthews, "Governance and state capacity", 282
15 Charles Polidano, "Measuring Public Sector Capacity", World Development, Vol.28 (2000), 805-22.
16 Linda Weiss, *The Myth of The Powerless State* (New York: Cornell University Press, 1998), 4
17 Weiss, *The Myth*, 4
18 Weiss, *The Myth*, 24-38
19 Weiss, *The Myth*, 35

him, in the states with strong state capacity, governments provide the state a fair degree of autonomy to undertake measures more in line with national, rather than parochial interests, deducing that the quality of state capacity is primarily a function of not being captive to narrow vested interest.[20] Meanwhile, the label of weak state does not refer to the states with a weak government but rather the states that are captive to vested interest and, therefore, prone to extensive rent-seeking activities.[21]

Overall, although the definitions of state capacity differ from scholar to scholar, the similar factors in their studies indicate, essentially, that state capacity can be reflected in a government's ability to achieve the development of the state. Japan is an ideal case to see state capacity and its impact on the economy. While Johnson takes Japan as the typical mode of "state-led" economy, Beeson mentions that state capacity lies at the core of idealized depictions of it.[22] Therefore, it is necessary to first study Japan's mode.

1.2 Japan and Japan's state capacity 1945-2000

From 1945 to 2000, Japan experienced a drastic rise and fall in economic performance. Unlike "standard" capitalism, postwar Japan developed a different economic mode to the Anglo-American mode — the CME distinguished Japan from other capitalist countries. The Japanese state was highly authoritarian;[23] bureaucrats had advantages, such as a high degree of legitimacy and a great deal of prestige, as well as what Evans called "embedded autonomy".[24] Japan has strong a strong state — that is, a state in which technocrats and bureaucrats enjoy disproportionately high levels of power and wield a variety of tools to enforce their will. For Japan, the key state bureaucracy MOF, and its bank the BOJ and the MITI, have played pivotal roles

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20 Khosla, "State and Economy", 42

21 Khosla, "State and Economy", 42

22 Mark Beeson, Developmental State in East Asia: A Comparison of the Japanese and Chinese experience, *Asian Perspective*, Vol.33 (2009), 10

23 Bruce Cumings, "Webs with No Spiders, Spiders with No Webs", in *The Developmental State*, ed. Meredith Woo-Cumings. (New York: Cornell University Press, 1999), 69

24 Embedded autonomy provides the underlying structural basis for successful state involvement in industrial transformation, the bureaucracy enjoyed a certain kind of autonomy (Peter Evans 1995 12)

in intervening in Japan's economy. The Japanese mode also draws the attention of many researchers. For example, Hall discusses that it is the CME of Japan that contributed to the economic miracle, stressing the role of government in making economic plans and industrial policies.[25] Weiss mentions Japan's mode as "the most extensive set of institutional arrangement for reaching agreement between government and industry".[26] Weiss also highlights the importance of "institutions", "insulated technocracies", and "bureaucratic capacities".[27] Beeson states the Japanese model was the key quality of Japan's success but not the market force.

Since the Japanese economic mode is closely related to the state, there are many studies about the role of the state in Japan's economy. On one hand, many scholars have talked about how the state contributed to the Japanese miracle. Johnson's developmental state conception was the pioneer in the studies of the Japanese state's role in its economy. He takes Japan as the model of the developmental state, arguing the Japanese state has given its first priority to economic development for more than 50 years,[28] and the pilot organization, like the MITI, is the key factor of Japan's miracle.[29] He also believes that All East Asian cases reflect particular forms of state guidance that were first demonstrated to be effective by Japan.[30] Pempel agrees with Johnson's statement of the development state, proposing the state's mission is the long-term national economic enhancement, and the active and regular intervention of the state in economic activities improved the international competitiveness of their domestic economies.[31] According to Weiss, the Japanese experience has emphasized the advantages of a publicly coordinated approach to industrial innovation.[32] Brødsgaard and Young say, in Japan, the market is able to work through the bureaucracy and party politics rather than in spite of them, and Japan is a typical

25 Peter A. Hall, and David Soskice. Varieties of Capitalism: The Institutional Foundations of Comparative Advantage. Oxford: Oxford University, 2001. 110

26 Weiss, *The Myth*, 55

27 Weiss, *The Myth*, 42

28 Johnson, *MITI*, 305

29 Johnson, MITI, 319

30 Chalmers Johnson, The developmental state: Odyssey of a concept, *in The Developmental State, ed. Meredith Woo-Cumings. (New York: Cornell University Press, 1999),* 40

31 T.J. Pempel, "The developmental regime in a changing world economy", in *The Developmental State*, ed. Meredith Woo-Cumings. (New York, Cornell University Press, 1999), 139

32 Weiss, *The Myth*, 52

example of a strong state.[33] According to Khosla, the Japanese state has an important role to play in mobilizing and allocating resources in the right direction, through regulation and control with a highly educated and competitively selected bureaucracy with sufficient freedom to formulate and implement policies in the national interest.[34] The Japanese state has primarily played the role of information provider to minimize market failures and also perhaps as an instrument to balance competing private sector interests.[35] Wade believes that Japan's superior performance is the result of heavy investment in internationally competitive, high-growth industries.[36] Beeson says Japan's economic renaissance was planned and realized as a consequence of the efforts of a bureaucratic elite working in tandem with the indigenous capitalist class.[37] Meanwhile, researchers also take the regional performance into the consideration of Japan's state capacity: Hatch mentions, in his book *Asia's Flying Geese*, that the famous "flying geese pattern" at the end of the 20th century was an expression of Japan's state capacity as well.[38] Beeson says "No East Asian country is more important to the region's future economic development prospects than Japan"; Japan's economic weight ensures its major influence in the region. Apparently, among the large number of the studies of how Japanese state guided the economy, many scholars share the opinion that the Japanese state was a key to Japan's success and have worked to explain it.

On the other hand, the Japanese government was also later taken as the "culprit" for its recession and for its economic performance. For its suffering in the 1997 financial crisis, Weiss says Japan was not a victim of the financial meltdown; rather the Japanese banking crisis was self-induced.[39] She believes Japan had been especially slow to respond to the existence of equally lengthy banking crises in other countries.[40]

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33 Kjeld Erik Brødsgaard, and Susan Young, Introduction: State Capacity in East Asia, in *State Capacity in East Asia: Japan, Taiwan, China and Vietnam*, ed. Brødsgaard, Kjeld Erik and Young, Susan,19-21, Oxford: Oxford University Press: 2000

34 Khosla, "State and Economy", 42-43

35 Khosla, "State and Economy" 59

36 Weiss, *The Myth*, 46

37 Mark Beeson, *Regionalism and Globalization in East Asia: Politics, Security and Economic Development*. (Basingstoke: Palgrave Macmillan, 2014), 131

38 Walter Hatch, *Asia's flying geese: how regionalization shapes Japan*. (Itacha: Cornell University Press, 2010), 4

39 Linda Weiss, "Developmental States in Transition: adapting, dismantling, innovating, not 'normalizing'", *The Pacific View*, Vol.13 (2000),38

40 Weiss, Developmental state, 45

Beeson states that some elements of Japan's contemporary political economy are highly inefficient and seemingly undermine the competitive position of its internationally-oriented businesses.[41] In Vogel's study, the Japanese state was blamed to a much greater extent for the stagnation.[42] Ozawa mentions that excessive government involvement and a new-mercantilist industrial policy are the reasons for the "Japanese disaster".[43] Cowling and Tomlinson blame the Japanese crisis directly on the state's strategic failure. Garside believes the government failure led to the great stagnation.[44] Beeson states that since Japan's policy makers did not solve the domestic problems, Japan shows an apparent inability to play a more decisive regional leadership role.[45] It is of interest to discover the entirely different commitments toward the Japanese government, as Beeson asks, "Why did the model of political and economic organization that had underpinned Japan's astonishing recovery from the devastation and defeat of the WWII suddenly seem unable to cope with the less dramatic challenges of managing a mature and seemingly highly successful economy?"[46]

Apparently, many studies have been conducted on state capacity and the role of the Japanese government in its economy, but not many studies have related the two factors and put them into a broader circumstance. For countries that develop relatively late, state capacity is a vital role in their economic development. When the market is not mature enough to allocate resources efficiently, the state is in a better position to overcome market failure, thus the state's ability determines the quality of the state intervention. However, how does one evaluate the state capacity of Japan when Japan shows astonishing success and stagnation? How does state capacity contribute to Japan's success and stagnation respectively? Also, if state capacity has played a pivotal role in Japan's own development path, what is its impact on Japan's regional

41 Beeson, Mark. *Reconfiguring East Asia: regional institutions and organizations after the crisis.* (Routledge, 2014),254

42 Steven K Vogel, *Japan Remodeled: how government and industry are reforming Japanese capitalism.* Ithaca, N.Y. etc.: Cornell University Press, 2006,

43 David Bailey, "Explaining Japan's Kudoka [hollowing out]: a case of government and strategic failure?", *Asian Pacific Business Review*, Vol.10 (2003), 1

44 Garside, William Redvers. *Japan's great stagnation: forging ahead, falling behind.* (Edward Elgar Publishing, 2012), 110

45 Mark Beeson, "Japan's reluctant reformers and the legacy of the developmental state." Governance and Public Sector Reform in Post-Crisis Asia: Paradigm Shift or Business as Usual (2003): 25

46 Beeson, Japan's, 25

economic status?

1.3 Method

Document analysis would be the method of this thesis. The main materials include secondary literature and some official historical data. By collecting and analyzing the literature and data on state capacity theory, Japan's institutions and economy, and East Asian regional economy, the inner connection between these elements will be identified, then the impact of state capacity on Japan's regional economic status will be found.

Chapter 2. Before the collapse: the "state-led" Japanese miracle

"Miracle" is the word often used to describe the economic development of Japan during the post-war period. Indeed, from the ruins of WWII, the Japanese people built one of the most developed countries in the world in just a few decades. Japan's gross national product grew at an average of about 11% per year from 1962 to 1973, while its share of world trade quadrupled from 2% to 8%.[47] Additionally, Japan developed astonishing high-technology industries, which devoted much to its further sustainable development. Consequently, on the one hand, Japan's developing model was widely imitated in East Asia;[48] on the other hand, Japan itself became the engine of the regional economy, acting as the head of regional development. As Beeson mentioned, "its overseas economic expansion of Japan-based companies has made Japanese economic entities major determinants of economic outcomes in East Asia."[49] Although many factors, such as the support of the US and the hard work of the Japanese people, have contributed much to Japan's miracle, historically, the idea of a powerful,

47 Pempel, "The developmental regime", 147
48 Johnson. *MITI*, 90
49 Beeson, Reconfiguring, 140

interventionist state playing a pivotal role has contributed to a good deal of Japan's post-war success.[50] After all, its success was due to Japan's ability to design policies that fit diverse priorities in different developing periods and to implement its policies to achieve the goal. In other words, Japan's strong state capacity contributed to its great post-war economic development and its leading role in the region.

2.1 State capacity and the domestic economic power

2.1.1 National industry policies

In the period immediately following WWII, the active intervention of the Japanese state was considered imperative in the poor economy to enable it to come out of a "vicious circle of poverty".[51] In a state of devastation with an incomplete market mechanism, if Japan allowed the market to allocate resource development, there was a significant chance that Japan would follow the most common developing trajectories of capitalist economies, starting with light industries. It would be almost impossible to achieve the miracle in the industrialized world if Japan followed market guidance. It was the Japanese government that set strategic targets and designated priority industries to "catch-up" with developed economies, reallocating resources itself instead of leaving it to the market. Industrial policy was the key policy instrument used to set the developing direction in each period. Since 1956, the Japanese government has set 12 national economic plans to guide the economy. Utilizing policies, the government gave the promising industries protection and growth. Generally, the Japanese government's creation of industrial policies can be divided into three periods: the full-recovery period (50s), the adjustment period (60s), and the transmission period (70s). According to Johnson, the industry policies made by the elite state bureaucracy were one of the key elements of the Japanese model.[52] Japan displayed a strong capacity in designing the industrial policies for each period.

The full-recovery period

From the end of WWII until the mid-1950s, by making production systems a

50 Beeson, *Regionalism*,125
51 Khosla, "State and Economy", 37
52 Johnson, *MITI,* 314-320.

priority, Japanese government laid the solid foundation of Japanese economic recovery and prosperity. When resource allocation was extremely limited, the coal and steel industries were prioritized. The priority was especially apparent in the 50s. To promote the recovery of coal and steel industries, the Japanese government made relative priorities policies in finance, price support, and supplies, helping to build a generally appropriate environment for the priority industries: the two industries enjoyed 80% of the government's investment loans, as well as price supports which accounted for 24% of the government's fiscal expenditure;[53] the priority industries enjoyed 80% of the minimum demand of the means of production, while the others only enjoyed about 20% to 30%; the coral industry enjoyed 44% of all price subsidies in 1947.[54] According to the data, the result of the priority policies was impressive and successful: until 1949, the production of the mining industry had recovered to 81.6% of the prewar level, and the steel industry also recovered over 80% of the prewar level.[55] As shown in Table 2-1, Japan's economic growth rate was astonishing at that time. By improving the supply and demand situation of the raw materials for the basic industries, a virtuous circle between the two main raw material industries was established.[56] In fact, coral and steel, as two main raw material industries, were the breakthrough point to drive all industries. In other words, the realization of the priority resulted in the increase of basic materials, then the increase of means of production, and eventually the increase of the means of consumption. Thus, the priority production policy settled the first step of recovering.

Table 2-1. The general condition of the increase of the Japanese national economy (%).[57]

	1946-1950	**1951-1955**	**1956-1960**

53 □□□□□□□□□□□□□□□□□□□□□□□□□□69[Jie Zhang, Xin Zheng, *The Mix Market Economy of Japan* (Wuhan: Wuhan University Press), 69]

54 □□□□□□□□□□□□□□□□□□□□□□□□□23Sun, Zhizhong, The Theory of Property and Declination: Japan's postwar economic history, (Beijing: People's publishing house, 2006), 23

55 □□□□ □□□□□□□□□□□□□□□□□□□1981 □□p7Kanemori Hisao. The Japanese economy encyclopedia (Tokyo, Nekki), 7

56 □□□□□□□□□□ □□□□□1985 □□p87[Masamura Samihiro, *The Post War History* (Tokyo, Chikuma Shobo,1985), 87]

57 □□□□□□□□□□□□□□□□□□□□□□1993□49 □ Huai Chen, *The studies of Japan Industry Policies* (Beijing: China Renmin Univeersity Press, 1993), 49

Economic growth rate	10.0	8.2	8.7
Industrial and mineral industries growth rate	29.1	11.3	16.3

The adjustment period

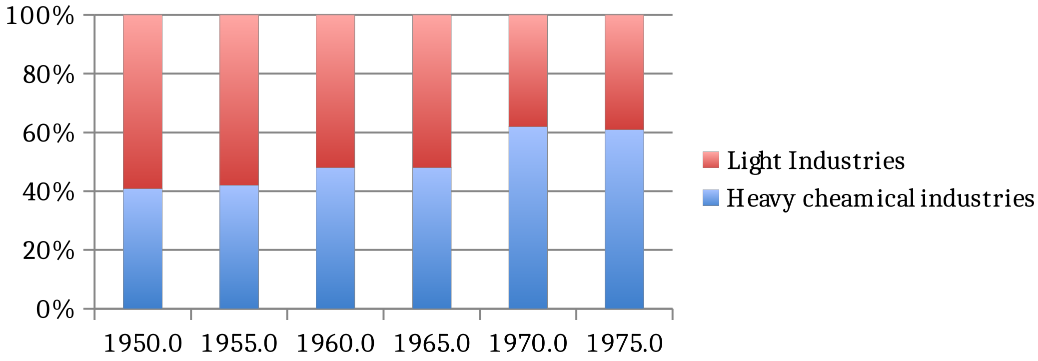
Since the mid-50s, the Japanese government's heavy industrialization strategy was a key factor in the rapid development after the re-establishment of the basic raw material industries. Developing heavy chemical industries and introducing advanced techniques were the main characteristics of this period, both of which were fundamental in Japanese development history. Firstly, the heavy chemical industry is a reflection of the latest techniques, promoting labor productivity and emerging industrial sectors; the additional value of the heavy chemical industry is much higher than the light industry. Secondly, introducing advanced techniques saved considerable research input and time for Japan to "catch up", helping to update Japan's industries. Unlike the direct control and guidance of the priority industrial policies, the Japanese government generally turned to use the fiscal and financial policies, such as tax reduction and interest subsidy, and concessional loans to support the major industries indirectly, including fiber, electric, and machinery.[58] Furthermore, the Japanese government generously introduced advanced techniques with strict restrictions against foreign exchange to other industries. Consequently, the rapidly developing heavy chemical industry led to the fastest economic growth period of Japan. Among the main capitalist countries (The US, The UK and France) in the world, Japan had the lowest proportion of heavy chemical industries in the 1960 (53.7%), and in the 1970s, it had the highest proportion (68.9%).[59] The growth of heavy industry is also clear in Figure 2-1. The Japanese government had realized that the state had to foster the industrial sectors rather than only relying on the market cycle. Through the recovery and rationalization of the industry, not only did the Japanese economy recover completely and develop drastically, but it also built up the leading role of the state in regulating the economy.

Figure 2-1. The variation of manufacturing industries[60]

58 □□□□□□□□□□□□□□□□□□□□□□1986 □ 3 □□8 [Wancang Tian, The Japanese government's industrial policy. *Japan Studies*, 1986 Vol.3, 8]

59 Sun, The Theory, 127

60 Komiya, *Japanese Industrial Policies*, 50



The transmission period

Gradually, the Japanese government transitioned to knowledge-intensive industries in the 1970s because of the high consumption of energy and the pollution problems caused by heavy industries and the oil crisis in 1973. This policy is another major decision, made by Japanese government, that established a general development direction for Japan, which lasted through the 70s and 80s, and which even now, brings Japan enormous economic benefits and development vitality. In the first period of the development of knowledge-intensive industries, the Japanese government limited the increasing speed of heavy industries to promote the knowledge-intensive industries.[61] From 1975 to 1979, for steel, petroleum products, and chemistry, the investment volume declined by 30%, 32%, and 37%, respectively. Counter to this, the investment volume increased 1.14 times for precision machinery.[62] As a result, in the fields of microelectronics, semiconducting, and production automation, Japan made great achievements. In 1980, Japan's high-technology trade surplus to the United States had reached three billion dollars.[63] Later, the Japanese government shifted the knowledge-intensive industry policies into creativity knowledge-intensive industries. By focusing on developing independent sophisticated technologies, Japan made further improvements in developing the knowledge-intensive industry. The knowledge-intensive industry became a dominant element in the Japanese economy, contributing to promoting the updating of the entire industrial structure. Simultaneously, with the maturity of both Japanese businesses and markets, the Japanese government adjusted its role in the economy, intervening in

61 □□□□“□□□□□□□□□□□□□”□□□□□□□□□2006 □ 2 □□68[Siyi Qin, The evolution and characteristics of Japanese industry policies, Japan Politics and Economy, Vol.2 (2006), 68]

62 Sun, The Theory, 153

63 □□□□□□□□□□□□□□□□□□□□□□□□□□□□□□□□□□□ 1998□148[Bing Ding, *The Postwar Technology Revolution and Modern Capitalist economy* (Guiyang, Guizhou Press, 1998), 148]

the economy through consultation and advice instead of direct implementation of policies. In a nutshell, the government's industrial policy specific to different developing periods laid the solid economic foundation of Japan. Whether it was the priority production system that aimed to recover the basic industrial sectors, or the industry rationalization that aimed to develop the high added-value heavy industries and the transition to knowledge-intensive industries, the Japanese state showed its high quality of intervention in its economic development and industrial optimization. Before the collapse, Japan had become the most successful industrialized economy in the world.

2.1.2 Government-business

If the industrial policies reflect the state capacity of Japan from a macro economic perspective, the government-business is the reflection of this capacity from the micro economic perspective. As Johnson has stated, in the post-war period, by promoting and protecting *keiretsu* from any form of legal or financial challenge from outsiders and protecting the domestic economy from international competition, each individual industry thus enjoyed a stable, cooperative environment.[64] One clear lesson from the Japanese case is that the state needs the market and private enterprise needs the state; once both sides recognized this, cooperation was possible and high-speed occurred.[65] For the Japanese state, to implement its support to private business, three main tools were used: the financial support from the BOJ, the administrative guidance from the MITI, and the direct regulation of the "Old Boy" system.

Financial support from the BOJ and MOF

The state played a guarantor role in giving financial support to businesses. The BOJ, which is controlled by the government, supervised the economy indirectly through the main bank system.[66] The main bank system provided the foundation for corporate growth and played an important role in promoting corporate capital investment. Whether it was large groups or small-and-medium sized firms, all had the chance to be financed. During the post-war period, most enterprises had their main banks. In

64 Cumings, "Webs with No Spiders", 58
65 Johnson, MITI, 319
66 Pempel, "The developmental state", 149

table 2-2, it is clear that the rural financial institutions, i.e. main banks, were the dominant financial source for enterprises.

Table 2-2 The main source of Japanese poste war industrial finance (%).[67]

	Stock	**Bonds**	**Rural financial institution**	**Governmental financial institution**	**Special accounting**
1955	14.1	3.9	68.9	11.1	3.3
1960	16.1	5.2	61.2	5.5	2.0
1965	5.3	4.4	81.4	7.5	1.5
1970	7.9	2.8	81.2	7.2	0.8

Given the vital role of the main bank system, the state created intense protectionist gears in the system. On the one hand, although most banks were private financial institutions and often linked to industrial groups, they had to rely on the BOJ as lender of last resort. In other words, the BOJ is an instrument for the government to control the flow of funds. By providing public funding through public financial institutions to particular industries, the government showed its commitment to those industries, and the “window guidance”[68] from BOJ gave a signal to the private sector to move funds in that direction.[69] To provide stable financial support to the enterprises, the BOJ set low interest policies artificially, maintaining an interest rate level lower than the actual rate set by the financial market. Therefore, private banks could obtain industrial financing with proportionally lower discount rates to gain from the interest margin; enterprises could obtain loans with lower interest rates. A stable bank system contributes to lucrative banks and enterprises, as well as citizens’ confidence in the banks.

As Samuel has stated, “[the] Japanese state neither competes with, nor determines allocations by private banks. State financial institutions are more than additional creditors in the Japanese financial market, they are guarantors, protecting not just targeted industries but the banks as well. Protection is explicit in their character”.[70]

67 [illegible]2001 [illegible]146 [illegible][Deliang Pang, *The Studies of Modern Japanese Enterprises Property Right System*, (Beijing: China Social Sciences Publshing House, 2001), 146]

68 Window guidance is the process by which the BOJ is believed to have persuaded the commercial banks, to provide loans to industries targeted by the government.

69 Khosla, “State and Economy”, 51

70 Richard J. Samuels, *The Business of the Japanese State: energy markets in comparative and historical perspective*, (Ithaca etc.: Cornell University Press, 1987), 276

Private banks are disproportionately important in shaping the way the state intervenes in markets. The pervasive role of the state in Japanese development was usually preceded by extensive accommodation to private interests.[71]

Administrative guidance from the MITI

The MITI, according to Johnson, was believed to be the pilot organization in Japanese development.[72] Its small size, its indirect control of government funds, its "think tank" functions, its vertical bureaus for the implementation of industrial policy at the micro level, and its internal democracy are all characteristics of the MITI.[73] In the 1950s, the period just after the priority production system, the administrative guidance of the MITI was rare since there were more direct confirmed laws and regulations. From the 60s, the administrative guidance for enterprises gradually became the main instrument. The MITI acts as the brain of the Japanese government's economic arm, applying detailed policies to the enterprises to help their development. There was no legal effect in administrative guidance; therefore, guiding or restricting decrees was more elastic and efficient than laws. The relationship between the MITI and businesses was more like cooperation than top-down management, and the MITI utilized administrative guidance to guide the developmental direction. For instance, in 1976 to 1979, through providing governmental loans and preferential policies, the MITI promoted the cooperation of the five main electronic firms in Japan to develop VLSI, overcoming firms' inability to develop VLSI separately. The development successfully narrowed the gap between the US and Japan in VLSI techniques and displayed the MITI's function as a "pilot".

The "Old Boy" network

The "Old Boy" (OB) network refers to the transposition of retired government officials into the private sectors, which was regarded as a "striking feature" of Japanese government-business relationships.[74] OBs are a direct tool for the state to implement regulation, and management of (non-transparent) regulation.[75] According

71 Samuels, The business, 275
72 Johnson, MITI, 316
73 Johnson, MITI, 319
74 Schaede Ulrike, "The "Old Boy" Network and Government-Business Relationship in Japan", *Journal of Japanese Studies*, Vol.21(1995), 293
75 Ulrike, "The 'Old Boy'", 300

to the data,[76] the proportion of OBs in the total number of board members in a firm doubled from 1979 to 1989. On the one hand, OBs act as monitors of existing regulation; the tight government-business relationship could minimize the cost of obtaining information via the OBs' network; on the other hand, since most OBs are the experienced former members of the elite bureaucracy, they can help with the development of enterprises. From the state capacity perspective, the OB network ensured the government could implement its regulation, and highlighted the institutional embeddedness of corporate strategies by Japanese multinationals. The Japanese government has played a vital role in supporting Japanese firms, and Japanese firms have acted as direct implementers in expanding Japan's regional influence.

2.1.3 The trade protected by the state

The Japanese government set the basic guideline of relying on foreign trade to stimulate the economy instead of establishing domestic public projects in the initial stage of the post-war period. It was based on the theory of Professor Ichiro Nakayama in consideration of Japan's low level of development, limited resources, and overpopulation at the time. It means Japan needed to expand international trade and participate in the international division of labor to develop the economy. Since the trade policy was established, trade protection provided by the state was the main characteristic in every developing stage of Japan's trade.

The quantitative restriction period

Before the 60s, trade protection was strictest because Japan's domestic economy was too weak to have advantages in global market competition. Since only the labor-intensive light industries, such as the textile industry, had a competitive advantage in international market, to avoid import production occupying the domestic market, the Japanese government took full control of foreign trade in general. The MOF used the control and quota system to dominate foreign currency, and limited the import of products and FDI that strictly intended to engage in management. In

76 Ulrike, "The 'Old Boy'", 304

particular, the Japanese government utilized quantitative restriction, which is the most direct and strict measure of restricting import products, to restrict the competitive products access to its market.[77] The quantitative restriction was the key policy to protect domestic industries and control imports before the 1960s. However, government control did not mean a full restriction on all imports. For average consumer goods, especially consumer goods that would have been competitive with domestic infant industries, the government had stiff restrictions; for the essential energy sources, industrial raw materials, or advanced technologies and equipment, not only did the Japanese government relax the restrictions but also even encouraged imports, offering support such as tax reduction. Table 2-3 shows that for raw materials, the Japanese government gave a lower effective protection; for consumer goods, the Japanese government almost doubled the already high protection rate. In short, the stiffer and direct government regulation to trade created a relatively "safe" developing environment for domestic infant industries. The restriction of import was the main protectionist policy at that time, buying time and conditions for the damaged industries and making space for new domestic industries.

Table 2-3. Effective rates of protection in Japan (percent)[78]

Type	**1963**		**1968**		**ERP**	**NRP**
	NRP[79]	ERP[80]	NRP	ERP	1963	1968
Raw materials	3.1	0.8	3.9	0.9	-2.3	-3.0
Producer goods	13.7	29.6	15.2	22.3	15.9	7.1
Consumer goods	21.6	44.6	23.6	35.8	23.0	12.2

The tariff barrier period

After the strict restriction period, the Japanese market was still relatively closed to foreign products and capital, even though Japan had participated in the OECD and GATT. The Japanese government utilized tariffs instead of quantitative restrictions to protect the domestic market. The government consummated its tariff system to "resist" the impact of global trade liberalization on its domestic market. Both the tariff

77 □□□□"□□□□□□□□□□□□□□□□"□□□□□□□□□□□□□□□□2005□79 [Mingyuan Li, "The combination of Japanese industrial policies and trade policies" (PhD diss., University of International Business and Economics, 2005), 79]

78 The World Bank. *The East Asian Miracle: Economic Growth and Public Policy* (New York, Oxford University Press), 296

79 NRP=Nominal Rate of Protection

80 ERP=Effective Rate of Protection

level and tariff range were regulated at a high level; The diverse and priority tariff structure was more flexible for the government and allowed it to trim the sails, endeavoring to attain buffering time in order to protect domestic industries. While Japan was protecting its domestic industries, it utilized trade liberalization to promote its exports in the global market. The government made new policies to stimulate export, from setting new export organizations to improving export financial institutions, setting specific taxation and expanding export insurance. As Table 2-4 shows, these trade policies brought significant consequence: in 1960, Japan's export growth speed was double that of the global average;[81] the proportion of traditional textile products gradually decreased as a proportion of its exports, while the proportion of heavy chemical products increased drastically. Simultaneously, from 1950 to 1964, in 15 years, Japan only approved 23 million dollars that engaged in management.[82]

Table 2-4. A comparison of some economic data before and after trade liberation.[83]

	1955	**1960**	**1965**
Per GNP (USD)	273	468	919
Share of global export market	2.4%	3.6%	5.1%
Rate of trade liberalization	16%	37%	93%

The non-tariff trade protection period

The Japanese state did not give up trade protection even when it faced huge international pressure in the 70s and 80s. Unlike in the 1960s, the trade friction between Japan and its trade partners had been aggravated by the Japanese productions increase in international competitiveness as well as a huge trade surplus. Not surprisingly, since the 1970s, Japan's export products were mostly products with high value elasticity, and were in high export concentration.[84] Table 2-5 shows increasing knowledge-intensive productions and decreasing basic productions along with time. During the five years between 1981 and 1986, Japan's trade surplus increased 8.8

81 Sun, The Theory, 160

82 Tian, The Japanese government's industrial policy, 10

83 □□□□□□□□□□□□□□□□□□□□□□□□□□□□□□□□□□□□1982[Chinese and Japanese economy experts ed. Modern Japanese economy Encyclopedia (Beijing, China Social Sciences Press, 1982)].

84 Sun, The Theory, 179

times.[85] Consequently, other developed countries, headed by the US, urged Japan to eliminate the tariff barrier, opening the market further. Facing huge pressure, the Japanese government transferred main trade protection measures from tariff to non-tariff restriction, such as raising health quarantine or effluent standards, and some other non-visible rules. Although it seems like Japan had a more liberated market, these non-tariff barriers were the "invisible hands" that protected Japan's market, limiting the accession of foreign productions.

Table 2-5. The proportion of Japanese main export products (%). [86]

	Food products	Fiber products	Chemical products	Metal ware	Steel	Machinery	Automobile	Other
1960	6.3	30.2	4.5	14.0	9.6	22.9	1.9	22.1
1965	4.1	18.7	6.5	20.3	15.3	35.2	2.8	15.2
1970	3.3	12.5	6.4	19.7	14.7	46.3	6.9	11.8

In conclusion, as an export-oriented economy, Japan's economic development greatly relied on foreign trade. The Japanese state gave full protection to its trade in every developing stage, even under huge international pressure, which resulted in huge trade surplus and capital accumulation. However, overemphasizing exports brought serious trade friction and deep-rooted crisis for Japan's further participation in globalization, which will be discussed later in this thesis. Japan's advanced industrial structure and capital created conditions for its expansion within the region.

2.2 State capacity and the expansion to the region

Historically, Japan had a vital position in East Asia as both a development model for other aspiring industrial economies, and as the principle motor of regional

85 Sun, The Theory, 179
86 Historical Statistics. Ministry of International Affairs and Communication. Japan

economic integration.[87] While Japan emerged as the principal regional engine of economic development, its expansion into the region was largely driven and managed by the Japanese themselves, in line with domestic imperatives,[88] who enjoyed the leading economic status in the region. Although it is widely believed that Japanese MNCs are likely to be major characters, the Japanese government plays a role that cannot be ignored in positioning Japan as the economic leader in East Asia. It encouraged the off-shore migration of declining industries; provided Japanese business with technical assistance, advice, insurance, and capital and facilitated the control of strategically important resources through the sophisticated deployment of ODA packages for host nations.[89]

ODA and Loan

Despite commercial investment, the Japanese government constantly provided the ODA with the means for cooperation to East Asian developing countries. For instance, in 1990, more than a third of Indonesia's $41 billion rebate was owed to Japan; in 1993, the Japanese government donated $4.9 billion to the whole East Asian region.[90] Japan was also the largest donor of the TASF of ADB, occupying 57% of the whole fund. Hatch and Yamamura argue that the impact of the ODA is actually much more than a state purchasing influence in East Asia.[91] In other words, they mastered the fine art of networking in East Asia, a region in which most countries do not have a modern legal framework for commerce. Therefore, the money gave Japanese business opportunities in an environment lacking comprehensive legal systems.

Flying geese pattern

Unlike the ODA, the influence of the Japanese state in the formation of the flying geese pattern[92] is more indirect. From the 1960s to the early 1990s, a complete industrial pattern formed in East Asian economy. In this pattern, Japan was the "lead

87 Beeson, Regionalism, 131
88 Beeson, Regionalism, 169
89 Beeson, Regionalism, 170
90 Walter Hatch and Kozo Yamamura, *Asia in Japan's Embrace: building a regional production alliance.* (Cambridge: Cambridge University Press,1996), 130
91 Hatch and Yamamura, Asia in Japan's Embrace, 131
92 The flying geese pattern was first raised by Kaname Akamtsu in 1932, indicating the trajectories of Japanese industrial structure; then, it was introduced to the studies of the industrial division of East Asia by Kiyoshi Kojima.

goose” in the regional order, followed by the NIEs, then ASEAN, and China. Given the rapid upgrading of Japanese industrial structure, Japan transferred the industries in which it no longer enjoyed comparative advantages, such as labor-intensive industries and high energy-consumption industries, to NIEs that had greater cost advantages, then NIEs “passed down” these industries to ASEAN and China, after the NIEs updated their industrial structures.[93] Japan acted as the capital and techniques supplier in this pattern, providing capital and technique flows to promote a virtuous cycle of industrial sequence within and between the host countries in the region.[94] The direct actors were JMNs which brought investment and construction to the other Asian countries. The FDI from Japan to the ASEAN4 was $2.2 billion in 1985 and $23.2 billion in 1990. FDI played an unintentional bottom-up role in integrating East Asia, through which JMNs now extend their global reach to numerous parts of the region.[95] There is no doubt that much of this investment was welcomed by the host countries and has played an important role in accelerating the course of development across the region.[96] Table 2-6 displayed the large scale and a drastic increase of Japan’s investment in the region. Japanese investment contributes much to accelerating the course of development across the region. There is no doubt that, historically, Japan has been a central element in East Asia’s economic takeoff.[97]

Table 2-6. Japan’s outward FDI by country (balance of payments basis, net, and flow)[98]

(Unit: US$ Million)

	1987	**1988**	**1989**
China	177	513	686
Asia NIEs	1671	2071	3427

To encourage updating the domestic industrial structure, as well as expanding the regional influence, in addition to the ODA and loans, the Japanese government implemented policies for overseas investment, including liberating the limitations of JMNs and the liberation of the foreign currency, giving subsidy measures to investment. Hatch has argued that Japanese bureaucrats wanted to buy some time in the face of global market and political forces, by extending the administrative and

93 Hatch, Asia’s Flying Geese, 81
94 Hatch, Asia’s flying geese, 83
95 Pemple, Remapping, 149
96 Beeson, Regionalism, 170
97 Beeson, Regionalism, 170
98 Historical Statistics. JETRO https://www.jetro.go.jp/en/reports/statistics/

production networks that had come to dominate Japan's political economy in East Asia.[99]

2.3 Summary

In the few decades, after WWII and before the economic collapse, Japan showed strong state capacity in designing and implementing policies through its impressive economic achievement and regional influence. Firstly, state capacity played a pivotal role in establishing its economic power. Under the government industrial policy, Japan developed an excellent industrial structure, centering on high elasticity value production; with the support of the state, Japanese business grew rapidly and became the direct role of expansion overseas. Under the state trade protection, Japan accumulated a large scale of capital through a huge trade surplus. Secondly, with its powerful economic strength and support of the state, Japan invested in the region and then transferred its industries without comparative advantages into the region. Through this, Japan became the "lead goose" in East Asia in the 1970s, providing capital and techniques to the region and acting as the region's leader and engine. In short, the strong state capacity of Japan largely contributed to Japan's economic status in the region.

99 Hatch, Asia's flying geese, 81

Chapter 3. After the collapse: "state-led" Japan's recession?

The collapse of the bubble economy in the beginning of 1990s and the subsequent ten-year stagnation, as Vogel has discussed, is Japan's other economic performance that astounded the world.[100] Firstly led by the crash of the stock market and real estate market, and then by the bank crisis, Japan suffered heavy losses. The impact of this collapse on Japan is so profound that, not only has its domestic economy experienced around a 1% average GDP growth rate for over ten years, but also its economic status in East Asia has declined. As the state has played a critical role in leading the previous decades of economic development in Japan, the whole national economy has a strong dependence on the intervention of the state. Therefore, state capacity in the Japanese mode is particularly critical; once the government policy fails, it would lead to an intensively negative impact on the whole economy. In the bubble economy and the subsequent stagnation, declining state capacity was one of the main contributors, which eventually led to the loss of its lead-position in the East Asian economy.

3.1 State capacity and the collapse

3.1.1 Who burst the bubble?

According to Beeson, even though it is recognized that the appreciation of the yen under the pressure from the US was at the center of the bubble, the inappropriate measures of the Japanese government still contributed to the bubble to a significant extent.[101] In the 1980s, Japan and the other capitalist countries were all in a cyclical economic growth period; however, only Japan experienced an unprecedented bubble economy.

The formation of the bubble economy

Intuitively, because of the huge trade deficit between Japan and America, the American government put the Japanese government under intense pressure to agree the *Plaza Accord* in 1985, which aimed to appreciate the yen to stymie Japan's export.

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100 Vogel. Remodeled. 22
101 Beeson, Regionalism, 124

As a consequence, the value of the yen increased by 56% in trade-weight terms, and by 93% against the US dollar in 1985 to 1988.[102] Apparently, the currency appreciation would bring the waning of export and a rising cost of enterprises, damaging economic development; in fact, currency appreciation has never been a rare situation in international trade and many tools can be adopted to balance the economic condition. It was reasonable for Japan to utilize loose fiscal policies to stimulate economy to respond to the currency appreciation, however, given that the speculation was already prevailing in the Japanese market due to the cyclical growth period, the loose fiscal policies would worsen the situation. Nonetheless, Japan neither raised interest rates nor controlled credit growth. On contrary, the MOF still applied loose fiscal policies to stimulate economy. It made the reason for the bubble widely regarded as a major policy mistake later.[103] As a result, the excess monetary liquidity problem became more and more severe.

The burst of the bubble

The nonfeasance of the MOF firstly assisted to the growth of the bubble, later the responses of the BOJ pricked the bubble. The BOJ overshot the overheated economy and when it realized that the bubble had to be burst. The sudden drastic raising of the interest rate in May 1989 not only burst the bubble, but also eventually led to "the plunge in the stock and real estate market, a fully-fledged crisis of the financial system, and more than a decade of near-zero economic growth".[104] The collapse was a watershed for Japan's economy, marking a permanent end to the Japanese miracle. As a matter of fact, Japan also experienced an economic crisis in the 70s Oil Shocks, but the success of the adjustment policies led a transition to alternative energy-efficient technologies and products, helping the upgrading of industrial structure.[105] The formation of the bubble economy had its deep root in Japan's economy, but if studying from the direct reasons, from the frothing to the burst of the bubble, the state constantly kept acting as a negative actor, making the market crash more severe when it finally came, and failing to apply appropriate measurements to save the economy.

After the bubble

102 Beeson, *Regionalism*, 128
103 Beeson, *Regionalism*, 129
104 Vogel. Remodeled. 23
105 Khosla, "State and Economy", 50

The full consequences of the collapse became clear over the subsequent decade. The role of the state should have been especially important when the market failed; nonetheless, the policy decision driven by the pervasive influence of past practice has fostered post-bubble woes. The bank crisis and long stagnation were the two main consequences of the bursting of the bubble. For the bank crisis, the substantial capital loss which resulted from the burst of the bubble made it hard for firms to repay loans to banks; the state also failed to monitor banks effectively during the bubble period and after, and then moved too slowly to press the banks to write off nonperforming loans. Consequently, the enormous NPL became a severe burden for Japan in its efforts to recover the economy. Besides, the "no bank will collapse" phenomenon, shaped by the Japanese state since the postwar period, gradually burst with the bankruptcy of many banks. The bankruptcy of banks led to more collapses of firms. Furthermore, due to the prevalence of the NPL, existent banks were reluctant to lend, resulting in tight liquidity and the rate of business failure increased, eventually leading to the long stagnation. The BOJ lowered interest rates to stimulate the economy, however through doing this it relinquished the use of interest rate manipulation as a tool, as it lowered rates to close to zero,[106] and failed to expand the supply of money sufficiently.[107] Taking a general look at the interest adjustment of the BOJ, it shows that the BOJ allowed money base growth to rise too far in the late 1980s—from 6% in 1987 and 12% in 1989—and then allowed it to drop too far to in the early 1990s: to 2% during 1991-1993. Therefore, much blame for the deepening recession has been put on the BOJ.

In short, unlike the past decades, the Japanese state did not show its capacity during the bubble economy and the period just after, in both the capacity to construct efficient policies and to apply policies. The real GDP growth directly reflected the crash of the Japanese economy: 5.8% in 1989-1990, 3.3% in 1991, just under 1% in 1992, and 0.2% in 1993, -2.4% in 1994.[108] As public confidence in the banking system was shaken, consumption and investment have fallen, bank credit has declined, and economic activity has weakened.[109] The stagnation after the collapse reflected many

106 Vogel, *Remodeled*. 25
107 Garside, *Japan's great stagnation*, 86
108 World Bank Data. http://data.worldbank.org/indicator/NY.GDP.MKTP.KD.ZG?locations=JP
109 Weiss, "Developmental state", 49

weaknesses and inefficiency in the Japanese mode. Japanese enterprises, especially SMEs, relied heavily on the main bank system for financial support. Thus, the bank failure resulted in a particularly severe economic crisis in Japan. Since the 1970s Japan no longer had an economic sector that needed full protection; the overprotection to economic sectors would only bring reduced competitiveness and loss of energy efficiency in globalization. Under these circumstances the state needs to "step back" and not intervene more. Apparently the Japanese state gradually realized this and took some measures for liberalization.

3.1.2 Measures and reform

Through the great stagnation, the state started to rethink the whole state-led Japanese model under the new wave of globalization. Some statisticians believed the collapse was because of the pressure from the increased integration of international markets,[110] forcing an economy like Japan's to abandon their state-led closed market. Thus, in face of the irreversible global trend and the stagnated Japanese economy, adjusting to the new environment was the only choice. The Japanese government made a series of measures to stimulate the recovery of the economy in the 1990s, which was also a huge challenge for Japan's capacity. The government had to undertake drastic reforms before the economy could fully recover, in order to prevent other large-scale crises occurring before the government could begin effective reforms.[111]

The policies in the first-half 1990s

In the first-half 1990s, the Japanese government enacted mainly macroeconomic policies, concentrating on government expenditures. The government applied six stimulus packages including a public works package and tax cut,[112] utilizing the large scale of public investment to stimulate economy. However, the consequence was a huge deficit and improvement only appeared with the deficit finance applied. The conservative policies did not bring fundamental transformation to Japanese economy. The measures were criticized as "the distributive predisposition of the LDP", which

110 Khosla, "State and Economy", 39
111 Vogel, Remodeled. 29
112 Garside, *Stagnation,*103

led to "only little positive impact on the economy and wasted valuable resources."[113] Meanwhile, the large number of subsidies for enterprises did not create much achievement either. The main reason was the "no loser capitalism" philosophy; that the Japanese government promoted industrial winners during the high-growth era but then shifted to protect the losers.[114] Instead of developing new technologies, Japan devoted more to protecting the decadent, traditional industries. Offsetting strategic industry policy was a complex policy that included the sunset industry policy and agriculture protection.[115] The huge investment could have had a better result. As a matter of fact, the loose fiscal policy did take effect to some extent in the period of 1994 to 1996, however, when the economy expressed the tendency to recover, the government undertook tight fiscal policy immediately, placing the damaged Japanese economy under another shock. Under the uncertain circumstances, the "Big Bang" of financial reform added further insult to injury.

"Big Bang" reform

Since the former policies produced little effect, in 1996, Prime Minister Ryotaro Hashimoto's administration started a series of reforms whose core attribute was the "big bang" financial reform. The whole economic crisis was believed to be rooted in the financial sector;[116] according to Takahashi, "financial and corporate sectors delivering undoubtly depressed economic growth".[117]

The enormous NPL resulted from the expansion of bank business, the dispatch of the financial environment and financial ability resulted from the postwar bank business division from the MOF, and the low competitiveness in the international financial market resulted from the limitations of the Japanese market. The Japanese financial sector could not adapt to the new environment efficiently in the 1990s with the strong intervention of the government. In fact, financial reform has proceeded slowly since the 70s; the bursting of the bubble economy actually accelerated the

113 Garside, *Stagnation,*103
114 Vogel, Remodeled, 31
115 Weiss, "Developmental state", 26
116 Garside, *Stagnation,*103
117 Wataru Takahashi, "The Japanese Financial Sectors' Transition from High Growth to the 'Lost Decades', in *East Asian Capitalism: Diversity, Continuity, and Change*, ed., Andrew Walter and Xiaoke Zhang (Oxford: Oxford University Press, 2012), 213

reform process. The “big bang” aimed to reform, as well as de-regulate, reducing government intervention and privatization and liberalization, containing measures for diversification of investment and financial choices, improvement of intermediary agent service quality and fostering competition. Development of a user-friendly financial market, a credible, fair and transparent business system were also major objectives.[118] The comprehensive package of financial liberalization reflected the determination of the Japanese government at that time, however, as the “godfather” of the state-led model, Japan faced the stickiest example of path dependence. The Japanese state still retained much confidence in state-guided development from the postwar miracle. Even though the initial intention of the reform was “liberalizing” the economy, with the onset of national crisis, state intervention in many areas actually increased.[119] Compared with the more flexible personalized or atomized capitalist system, Japan’s state-led networked system was more difficult to adapt to structural economic change and corporate restructuring. Regarding the big bang of financial reform, Beeson considers the reform process “anything but a big bang”.[120]

Reform Obstacles

Vested interest groups became a big problem for Japan to reform. While the success of Japan was based on the ability of the government to distance itself from narrow vested interests, making it difficult for any significant rent-seeking activity,[121] it is still hard to avoid this problem after decades of governance from a powerful state. Some conservative bureaucrats and traditional industries as the vest interest groups were the core force to blocking the change. Even though with the development, the bureaucratic capacity has been weakened and networks also have loosened, the reform was insufficient to overpower long-standing institutions or unwind policy networks.[122]As Weiss mentioned, these obstacles made the “wait and see” solution more attractive than that of wholesale restructuring and writing off bad debt.[123] This

118 Takahashi, “The Japanese”, 215
119 Takahashi, “The Japanese”, 220
120 Beeson, “Development state”, 31
121 Khosla, “State and Economy”, 41
122 Karl J. Fields, “Not of a Piece: Developmental states, industrial policy, and evolving patterns of Capitalism in Japan, Korea, and Taiwan”, in *East Asian Capitalism: Diversity, Continuity, and Change,* ed., Andrew Walter and Xiaoke Zhang (Oxford: Oxford University Press, 2012), 60
123 Weiss, “Development state”, 46

hindered the reform measures. The real estate developers, construction companies and banks, are among the most important providers of financial support to the ruling party. Asset deflation was the single most important factor affecting the profitability of Japanese financial institutions; calling in loans and selling off the depreciated assets would therefore harm one of the main pillars of LDP power.[124] Moreover, the close relationships between bureaucrats and industry that were formerly seen as essential to the effective design and implementation of industry policies and state-led development were now associated with economic stagnation and self-serving relationships. Therefore, the reforms had only a limited impact.

In this collapse and stagnation, Japan's incapacity has been exaggerated; its weakness has been overplayed, and its crisis is of "temporary and limited significance" in the longer perspective.[125] In short, nowadays Japan's economy asked for a more liberalized environment, however, the state did not have the capacity to carry out the reform thoroughly and efficiently during the transition because of the path dependency and the vested interest groups. Therefore, the transition was only partial and state intervention remains significant in Japan.[126]

3.2 The regional economic status after the collapse

3.2.1 Japan's economic conditions

The global and regional structure all experienced drastic changes during the 90s. For Japan, losing the "lead goose" status in the East Asian flying geese pattern, and the predominant position in the region has been the most obvious transition. The changing economic status identifies to the economic conditions and economic relations Japan faces with other regional economies.

Recession and "hollowing out"

Fundamentally, the general recession of Japan's economic power was the most influential element. Since the collapse until the end of the century, the economic

124 Weiss, "Development state", 46
125 Weiss, "Development state", 49
126 Fields, "Not of a piece", 53

aggregate did not see an improvement; data shows that the economic aggregate in 2000 ($4.888 trillion) was even lower than it in 1994 ($4.907 trillion).[127] Simultaneously, under the influence of the yen appreciation, overseas manufacturing activities increased. There was a steady decline in domestic manufacturing employment during the 1990s, from 15.9 million in 1990 to 13.21 million in 2000 while overseas manufacturing employment kept rising.[128] It was especially severe just after the bubble burst and just before 1997 Asian crisis; many firms moved out because of the recession which worsened the domestic stagnation in reverse. The large rate of firms "moving out", led to Japan's domestic deindustrialization, linking many problems of falling domestic output and rising unemployment. Bailey argues that the "hollowing out" was a government failure, since the policy towards building firms at home under protection was futile, as rising currency, driving home production less competitive and forced domestic firms to relocate overseas.

Stagnation of innovation

Japan did not make many impressive improvements in technologies in the whole of the 90s. The Japanese "miracle" in the first few decades largely relied on the upgrading of technology, however, since the end of the 1980s Japan focused more on financial speculation instead of industrial upgrading. Although Japan still surely had the greatest technological capabilities, it was no longer as distinctive in terms of its actual economic role. Besides, as mentioned previously, when the Japanese government took measures to support the domestic economy just after the collapse, they devoted more energy to protecting traditional industries rather than new industries. As a result, within the area of competition of new industries such as the computer, telecommunications, or Internet industry, Japan did not take advantages in the way that it did in the electronics industry in the 70s, and the automobile industry in 80s. The slow updating of industries provided opportunities to other economies to catch up and develop rapidly under the wave of international industrial transition.

In short, Japan's economic conditions declined since the collapse in 1989. The recession, and the deep-rooted policy and strategic failure of "hollowing out"

127 World Bank Data. http://data.worldbank.org.cn/indicator/NY.GDP.MKTP.CD?locations=JP&view=chart
128 Bailey, "Explaining", 2

impaired Japan's domestic output and economy. The transfer of the emphasis of economic development also led to the lagging technical upgrading, giving other economies time to catch up.

3.2.2 Economic relations

Japan's deteriorative economic condition in the 1990s directly contributed to the new economic relations between Japan and other economies in the region. Japan used to "predominate" the East Asian economy through its position in the flying geese pattern. Nevertheless, accompanied by the recession of the economy and the stagnation of industrial upgrading, the crucial factors in the Japanese-led flying geese pattern — capital, technology — were gradually removed from Japan; Japan came down from its predominant position.

Still a supplier?

Under the support of the state, Japan used to be a main capital supplier. Since its economic power has been battered by the collapse, the booming FDI of Japan dropped from $67.5 billion in 1989 to $34.2 in 1992. Macintyre and Naughton identify Japan's changing role in the Chinese economy as an instance, and mention it as a reflection of the shift in Japan's economic position generally.[129] Before 1992, Japan was the 2nd largest foreign investor in China just after Hong Kong, accounting for 13% of the total FDI in China. However, with the deterioration which has come with its recession, Japan has failed to catch up, only ranking as 6th largest foreign investor in China in 1992. Given Japan's industrial power, strength in driving much Asian investment, as well as its proximity to China, and overall economic size, this is an extremely poor showing.[130] Due to the slight economic improvement in government deficit stimulation, and the intention to "escape" from the domestic stagnation, FDI from Japan kept increasing slowly from 1992 until the 1998 Asian crisis, however, the total amount was far less than it in the 1980s. Japan was not a major victim in the 1998 Asian crisis; the investment from Japan has decreased drastically again since the crisis.

129 Macintyre and Naughton, "The Decline" 89
130 Macintyre and Naughton, "The Decline" 89

Japanese banks also slowed the expansion of lending to Asia, and in some cases they even began to recall loans to compensate for the increasingly shaky financial situation at home.[131] However, East Asian economies did not show that they were influenced much by Japan's decreasing investment, maintaining growth at high-speed. Instead of Japan, the already developed NIEs undertook new roles of capital suppliers for ASEAN and China. This suggested that Japan's role as the financial support in the region was decreasing.

Shrinking gaps

While Japan was stuck in the recession, the industrial structure difference in the region was also evolving. The huge gap in industrial structures was a precondition of the flying geese pattern; in this pattern, other economies used to rely on Japan's industrial upgrading. Therefore, it is necessary for Japan to upgrade its industrial structure constantly, transferring production without comparative advantage to other economies to retain its lead goose position. However, as mentioned previously, Japan's stagnation severely obstructed its industrial development, and the government did not emphasize the technique of upgrading while the other economies in the region developed rapidly by catching up with the wave of the global industrial transferring, and absorbing techniques from other developed countries. Large amounts of capital from other developed economies like the EU and the US flowed into the developing regions of East Asia. With the shrinking of the gap of the industrial structure between Japan and its neighboring East Asian economies, the industry-complementarity decreased while, industry-competitiveness increased. Japan lost its previously held absolute advantage in industrial structures. According to data, the like products in the trade of Japan and NIEs accounted for 29.3% in 1970, 48% in 1990s.[132] It is also believed that because of the fear of the "hollowing out" of Japan's industrial capability, the government slowed the restructuring pace of Japan's core industries.[133] Meanwhile, Japanese high-technology manufacturers are using quasi-integration to forge vertical ties with Asian firms and carefully control the process of technology

131 Macintyre and Naughton, "The Decline", 90

132 [illegible] 1997[illegible]342[Bin Wang, The Studies of industrial structure in East Asian industrialization, Hangzhou: Hangzhou University Press, 342]

133 Macintyre and Naughton, "The Decline", 94

transfer, which made host countries dissatisfied.

In spite of this, Japan's economic position is fluid. On the one hand, Japan still remains a highly developed economy with solid economic foundation; on the other hand, Japan's reform is still in process; considering Japan now has more experience in facing crises, there are big possibilities for Japan. The situation in the 21st century is still changing, and several administrations have showed the intention to reform. But there is no single "lead goose" in East Asia anymore; it is a competition between every economy in East Asia. In May 2001, for the first time, the MITI white paper indicated that the flying geese era had come to an end and that this is the new era for full competition. Japan is still the most developed economy in the region, but not the leading one anymore.

3.3 Summary

As has become apparent, Japan's failure contains many elements of its own policy failure. The drastic changing outside environment and competitors from the world play a role, but it is also a reflection of Japan's declining state capacity. Japan did not perform well under the impact of globalization. Firstly, the state did not undertake appropriate strategies when the yen appreciated greatly after the Plaza Accord, making a series of mistakes from the formation of bubble to the crashing of the economy. Secondly, given the consideration of the vested interest groups and conservative policies, measures to save the economy were not implemented well, of which the most influential is the slow industrial upgrading. As a consequence, accompanied with its declining economic power, the gap between Japan and other regional economies, which was the key focus of the flying geese pattern, was also shrinking. It failed to keep the predominant position in the region, and the lead goose time ended at beginning of the 21st century. As Pemple mentioned, "The inability of successive governments to take effective steps to tackle the country's prolonged economic problems undermined any potential for Japan to assume a true leadership role in Asia."[134]

134 Macintyre and Naughton, "The Decline", 93

Conclusion

State capacity refers to the capacity of a state to design and implement appropriate policies. From 1945 to 2000, Japan showed the world its changing state capacity, accompanied with its dynamic economic performance and economic status. In the postwar period, Japan performed excellently in both designing and implementing policies, thereby displaying its strong state capacity. Firstly the state made respective industrial polices fit for different developing periods, and used a series of tools to ensure businesses followed the policies efficiently. While domestic industries kept developing, the Japanese state utilized strict trade protection to establish a safe environment with regard to international competitiveness. As a consequence, Japan developed a mature and advanced industrial structure and accumulated a large scale of capital. The state capacity led a domestic economic power that was solid enough to expand overseas, and constantly gave support to businesses overseas. The outcome proved that the strategy was productive; Japan became the engine and the leader of the regional economy, driving the whole region's development through transferring its industries with no comparative advantage overseas, and establishing a regional labor division. As the supplier of techniques and capital, Japan stood at the top of the East Asian industrial production chain. However, the state capacity has gradually lost its "magic" since the late 1980s — the start of the globalization. From the *Plaza Accord* to the bursting of the bubble economy, the Japanese state made a series of policy mistakes, which worsened its economic disaster. Although the state realized that its conventional protectionist policy could no longer fit with this new environment, the measures and reforms which aimed to rescue the economy were weakened because of vested interest groups. Not only was the economy stuck in stagnation for a decade, but industrial structure also almost ceased upgrading. While the state "led" the economy into tough situations, other economies in the region did not stop catching up with Japan, shrinking the huge gap between Japan and themselves. Therefore, the "state-led" Japanese economy found itself in a "state-led" stagnation; the inability to make policies fit the globalization period and the inability to overcome vested interest groups to implement the policies made Japan "lost" it a decade from 1990 to 2000. Simultaneously, Japan lost its leading position and the huge advantage it held in the region with its declining economic power. In short, state capacity has both an indirect and direct impact on Japan's economic status in the region. The indirect impact was the capacity to boom its economic condition, and then impact its economic status through the condition; the direct impact was the capacity to make strategies for regional expansion.

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