The Chrysanthemum and the Eagle

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The “Amerippon” Concept

Conditions for Leadership. Paul Kennedy’s *The Rise and Fall of the Great Powers* was highly acclaimed in Japan because it contains two messages that are welcome to Japanese ears. The first is that the age of the great power (America) is coming to an end. The other is that the age of Japan is about to begin. But the Japanese have interpreted Kennedy’s work in a much too subjective fashion. Furthermore, references to Japan can only be found on a dozen or so pages of this very thick tome.

Most Japanese readers bought this hefty history book to read those pages. Even the book’s author readily acknowledges this fact. In 1988 I was asked by a Japanese magazine to interview Kennedy, and two or three days before he was to go to Japan, I talked with him for a few hours in his office at Yale University. Primarily a military historian, Kennedy is a recognized authority in his field. He expressed surprise at the response *The Rise and Fall of the Great Powers* had received in Ja-
pan, though he noted with some regret that the only section most of his Japanese readers seemed to have read was the one in which he predicted that America will decline and Japan or some other country will come to the fore.

I must take issue with Kennedy in two areas. First, he cites America’s enormous defense expenditures as one of the reasons the country has declined. U.S. defense spending, however, is roughly 5 or 6 percent of the GNP, hardly enough to account for America’s decline. His argument seems even less relevant as we enter the post-cold war era and face the transitional problem of moving resources from the defense industry to nondefense industries, thereby incurring a “peace penalty” resulting from the difficult reallocation of resources. Kennedy may be an eminent historian, but his discussion of economic issues is somewhat amateurish. A more important factor in America’s decline, I think, is that the conditions for great power status—competitiveness, culture, and the very principles of nationhood—are giving way. In a competitive world, it is natural for the country holding the dominant, monopolistic position to feel secure and relaxed, thus slowly losing its competitive edge. Other countries use the dominant country as a target to be overcome, thus increasing their competitiveness and eventually overtaking their stagnant target. As a result, America is beginning to find it difficult to maintain its edge.

The other problem area is Kennedy’s lack of first-hand knowledge about Japan. When I visited him in 1988, he was about to make his first visit there. The ideas about Japan that he expresses in *The Rise and Fall of the Great Powers* are strictly secondhand. Possi-
Is a Pax Japonica Possible?

bly that is why he seems to think that in the future both Japan and China will become number one—he lumps the two countries together. I find this totally incomprehensible. Kennedy’s rationale seems to be that China is a vast country with a three- or four-thousand-year history. Egypt and India are also civilizations with four- or five-thousand-year histories, but that does not mean they can become future superpowers. The thought often occurs to me that, with some exceptions, Americans who have had no actual experience of living in the Far East are China fans. Perhaps because Americans of Chinese descent make up the largest part of the Asian community in the United States, Americans tend to associate all Asians with China and not distinguish between people from different Asian nations.

In short, Kennedy’s predictions have no solid historical foundations. They are only a matter of feelings. And because these feelings are pleasing to Japanese sensibilities, his book was very popular in Japan. For a short time Kennedy was lionized by the Japanese mass media, which hung on his words as though he were some kind of oracle. The Rise and Fall of the Great Powers also sold well in the United States, but many intellectuals were critical of the book. One of the first to criticize it was Harvard political scientist Joseph Nye, who in 1990 published a book entitled Bound to Lead: The Changing Nature of American Power, which refuted the fundamental assumptions of The Rise and Fall of the Great Powers.

Another critic was Zbigniew Brzezinski. The assistant to the president for national security affairs during the Carter administration, Brzezinski is the author of The Grand Failure, which was also much talked about
in Japan when it came out in 1985. In that book Brzezinski had accurately predicted that the fall of communism was more likely than an American decline. At the request of a Japanese newspaper I had a discussion with Brzezinski in January 1990. When I asked him what he thought of the Kennedy book, he replied that it is completely wrong. As a history book—that is, as an account of the past—it is excellent, but when Kennedy attempts to predict the future, his argument becomes quite faulty. When I asked him who would lead the world ten or twenty years from now, his reply was “America, of course.” In other words, there will be no Pax Japonica.

Brzezinski is not a member of the Chrysanthemum Club, but he has studied Japan closely and has even published a book on the subject. While he would not claim to be an authority on Japan, he lived there for a year on a Rockefeller Foundation fellowship and knows the country far better than many self-proclaimed experts. At the very least, the fact that his book, *The Fragile Blossom*, is not based simply on abstract ideas is commendable.

To my question whether Japanese leadership of the Asia-Pacific region is inconceivable, Brzezinski answered that it probably is. There are many conditions for leadership, he explained. Economic strength is one; population is another. No matter how strong Israel is, for example, it can never achieve world leadership. Even if there were ten fewer Arabs for every Israeli, the Israelis would still be outnumbered. Next, when all is said and done, military power is needed to protect economic power. And, finally, leadership cannot come
about without a culture or an ideology capable of leading the world. If Brzezinski had added one more item, religion, to his four conditions for leadership, the list would probably be complete.

How many of these conditions does Japan satisfy? In truth, all it has at present are economic power and a population of 120 million people. Japan certainly has its own religion, ideology, and culture, but these do not have the universal appeal of "life, liberty, and the pursuit of happiness." For Japan to become the world's leader, it is commonly conceded, is probably impossible. As mentioned earlier, leadership is not determined by consensus or mutual agreement. In a manner of speaking, a master-servant relationship exists in international relations. Moreover, history teaches that war has always preceded a change in leadership. The wars between Spain and Portugal in the sixteenth century and between England and Holland in the seventeenth century are good examples. If Japan tried to seize leadership without a war, other countries would be unlikely to align themselves with Japan unless it had a universal system of values or a universal appeal. Brzezinski illustrated this fact most pointedly when he asked how many countries in Asia would follow Japan. When Japan's military expenditures went over their meager limit of 1 percent of GNP, China, Korea, and Singapore all protested that Japan was rearming. The Japanese cannot assume leadership without military power, but Japanese military power is what other Asians fear most. It is impossible for Asia to call Japan "leader."

I believe Brzezinski's analysis is probably correct. A country, like a person, must have leadership qualities,
and it must be popular among the countries that it hopes to lead. Unfortunately, the people of the world do not much like today’s Japan.

*Are the Basic Assumptions in The Rise and Fall of the Great Powers Correct?* In the course of our conversation, Brzezinski also suggested that Japan put its great economic strength to good use internationally and globally. As a specific measure, he proposed the concept of “Amerippon”—that the United States and Japan should combine their strengths to influence the future course of the world.

What Brzezinski was saying is that America and Japan must find a way to join forces. Such an arrangement would make for smooth going in a number of areas. For example, America is more trusted in Asia than Japan is. Thus, negotiations there would go far more smoothly if America were in the foreground and Japan followed along behind than if Japan acted on its own. It is likely that only through such an arrangement—Amerippon—will Japan be able to gain a foothold in Asia and be respected.

A “Pax Japonica” certainly sounds more pleasing to the Japanese. It has a nice ring to it. In the 1980s before the collapse of Japan’s bubble economy and the succession of political scandals, some people believed that, just as the transition from the Pax Britannica to the Pax Americana involved a shift in power from one side of the Atlantic Ocean to the other, a similar shift from one side of the Pacific to the other was about to occur. Just as world trends moved from Yalta to Malta, this argument went, they were now moving in the direction of disarmament and a “peace dividend.” Soon the age
of military power would be over, and a new age of economic power would dawn. *Perestroika*, the rise of democracy in Eastern Europe, the collapse of the Berlin Wall, the dissolution of the Soviet Union, all made an opening for economic power. And economic power means Japan.

The Pax Japonica is a dangerous seduction, an unattainable dream, an illusion. In the past, world leadership has only changed hands after a victory in war. In the future this may not hold true, but it has been the case up until now. The present-day rationale behind military might among the major world powers is no longer its use for territorial expansion or to invade other countries but to protect one’s own economic interests. The logical conclusion to be drawn from this is: If Japan is truly aiming for world leadership, it must arm itself to protect both its supply line for essential energy resources and the assets it has invested in throughout the world. Then, even if a revolution like the one in Iran occurs, Japan would not simply shrug and accept its losses but would defend Japanese property even if, in some cases, that meant resorting to the use of force. Japan has no resources of its own. What would happen if there were another oil shock or if the Arabs banded together and refused to sell oil to Japan?

No matter how much economic power a country has, it cannot achieve leadership without the military force to back it up. How else could Japan protect its factories that are scattered around the world or the foreign assets it has spent so much money to buy? What could Japan do to defend its interests against confiscations or freezes? Political coups and revolutions have not been eliminated from the world. Indeed, the dissolution of
the Soviet Union and the end of the cold war have sparked a flurry of military uprisings in the new independent states. These civil wars can be explained by two basic forces, one *geoeconomic*, the other *geopolitical*. Geoeconomic forces rippling outward from a country trying to maximize its earning potential by going beyond its geographic borders are countered by a centripetal geopolitical force whereby groups within a country try to protect their own interests by identifying themselves as an independent nations. When the geopolitical force within a country is greater than the geoeconomic forces, civil wars such as the one in Bosnia are the net result.

Leadership means having the military capability to deal with all these risks. Right now the only country with that capability is the United States. The cost of leadership comes high. Is it really so necessary for Japan to become the dominant power? This should be where Japan can say “no.” The Pax Japonica is only an illusion. Brzezinski’s Amerippon is probably closer to future reality.

*The Behavior of a Superpower.* The suggestion that Japanese supremacy is an attainable dream surfaced intermittently in *The Japan That Can Say “No.”* I have always believed that nothing can be achieved unless people are basically optimistic, but, where Japanese supremacy is concerned, I am a pessimist. This is one subject on which I can only say “no.” Having lived and worked in the United States for more than thirty years, I am well aware of America’s strength, the latent energy of the country that holds the leadership role. This is not something that can be shaken, as Shintaro Ishi-
hara suggests, by bargaining with high tech or silicon chips.

American behavior might seem offensive to Japanese eyes, but it is simply the normal behavior of a country that has superpower status. There is a fundamental difference between a superpower and all the other countries in the world. On this matter, one particular memory has remained with me from my first visit to England in 1967. This was about the time when Japan was just overtaking Great Britain economically, yet the pride, arrogance, and offensiveness unique to a country that had long been the dominant power were still everywhere to be found.

A British colleague asked me whether I was an American or a Japanese. "What do you mean?" I asked. "Americans think only about money," he replied, "but we know that some things are more important than money." Britain was then showing the signs of a nation in decline, fretting about its rapid loss of ground to the United States. The proud vestiges of its former leadership status, however, still remained. Contemptuous of America's economic power, the British looked down on the United States as a country that knew only how to make money.

Japan finds itself in a similar position today. It too is regarded as a country that knows only how to make money, and its citizens are scorned as "economic animals." But having said that Japan is in the same position that America once occupied, I cannot go further and say that Japanese world leadership is also a possibility. The United States in those days had the world's strongest military power and a culture that it had inherited from Europe and had spread throughout the
world. Japan today has neither military power nor a universally accepted value system. That is why it is sometimes called “a faceless country.” Over the years I have advocated that Japan create an ideology, a Japanology, if you will, and not continue merely to make things and earn money. If it does not do so, but continues to behave as it has since World War II, far from becoming the supreme commander, it will end up just a rich noncommissioned officer.

When world leadership crossed the Atlantic, dominance in many other areas of activity also shifted from British to American hands. The study of economics was no exception; even academic disciplines cannot escape the influence of superpower politics. Britain is the birthplace of modern economics. Until world leadership shifted to the United States, there was a tendency among economists to believe that all the views held by British economists had to be correct. This assumption continued into the 1960s. When I went to Cambridge, the study of economics in England was in its final stages of brilliance, and British economists were extremely arrogant, haughtily confident that it was impossible to study economics anywhere outside Britain. Twenty-five years later, however, British economics has not retained even a trace of its former glory. During those years preeminence in the study of modern economics has shifted to the United States.

We Japanese are apt to forget that, although the United States may not be as all-powerful as it once was, it is still a superpower. Why are America’s rules the best? Why do the Japanese have to follow them? The answer is always the same: because America is a superpower.
Paul Samuelson, the first American Nobel prizewinner in economics, regularly comes down from Boston to New York as a visiting professor at the Center for U.S.–Japan Business and Economic Studies. Samuelson and I are good friends and we argue a lot. One day I said, "If we were arguing in Japanese, I wouldn’t lose," to which he laughingly responded, "Is English that difficult?" The truth of the matter is that in important discussions it is frustrating to use a language that is not your own. Japanese have a serious handicap in that regard. A superpower has the advantage in many ways. Its rules, language, and currency circulate freely throughout the world. No Japanese, however, can venture forth into the world without first acquiring some dollars and a command of English. Just as we change yen for dollars in the exchange market, we must continually translate from Japanese to English. This requires an enormous effort. The citizens of a superpower do not need to make any effort at all. They do not need translation machines in their heads, as other nationalities do. Americans enjoy the special privileges of world leadership.

In its dealings with the United States, Japan must not forget that America is a superpower and that superpowers have special privileges. It must also try to understand the feelings of a superpower that is in a state of relative decline. This does not mean being servile or submissively following America’s lead. The relationship between the United States and Japan can be compared to the relationship between father and son or between older and younger brothers. A father has contradictory feelings—he frets at his declining strength and wants to assert his authority. A son should show
respect and be understanding. When seen from Japan, a country that has never held world power, America’s pride and arrogance certainly seem offensive. But it is even more difficult for America, which has reigned supreme for so long, to change its patterns of thought and action. The real reason that frictions between the United States and Japan have worsened lies in this fact.

If a just, impartial God really exists, and if he were asked to decide which side is playing fair—Japan or the United States—he might very well decide in favor of Japan. Since the war, Japan has undeviatingly followed the course laid out for it by America. It has worked hard to make good products and offer them cheaply to consumers worldwide, economized at home and saved its money, lived in peace and not gone to war. God might shake his head in wonder that Japan is now being criticized by the United States for following this course. But the logic of a superpower is like the logic of an aging father. A father will naturally criticize a son who disobeys him, but even when the son does exactly as he is told, the father will still criticize him if he poses a threat to the father’s existence. A superpower can make any rules it likes; the Super 301 clause is a case in point. The United States naturally feels that the rest of the world “ought” to do as it says.

What can Japan do to eliminate that insulting “ought”? Barring Japan’s fighting a war with America and winning, it is inconceivable that America would say to Japan—as Shintaro Ishihara seems to suggest—”You have beaten us technologically. Please help us out by selling us computer chips.” A superpower does not operate in this way. Before it reached that point, it would put a freeze on Japan’s assets or cut off its oil
supply. It is naive to think that America would not go that far.

The lengths to which America will go can be seen in the policies it has used to contain the Soviet Union since World War II. Those excessive red witch hunts, the COCOM regulations, and the numerous economic sanctions have finally led to perestroika. The end of the cold war is a victory for United States world leadership. Now that communism has been defeated, what if the United States decides to focus all its attention on Japan? Should Japan once again "endure the unendurable" if the United States decides to punish Japan for what it believes to be unfair practices? Shintaro Ishihara can say "no" to that question, but I cannot. Instead I would ask what other options we have. We Japanese must exercise our imaginations. I will discuss my thoughts on this later, but one alternative would be for Japan to express itself clearly in negotiations with the United States and not behave manipulatively as when it uses foreign pressure (gaiatsu) as an excuse to enact unpopular, but prudent, domestic policies.

The Fading Reputation of Japanese Management

The Kanban System: Tyranny over Subcontractors and Sub-subcontractors. In the early 1980s Japanese management was highly touted in the United States, and American business schools scrambled to introduce courses on the subject. Now, however, Americans are interested only in certain features of Japanese management and no longer regard it as a model. Why this
change in attitude? After careful analysis Americans came to realize that the efficiency of Japanese-style management is achieved at the expense of the Western concepts of life, liberty, and the pursuit of happiness.

Today when I ask students what Japanese management is, the more flattering replies are “lifetime employment,” “the seniority system,” and “labor-management collaboration.” Some students, however, jokingly reply, “doing group exercises at three o’clock, then drinking with the boss, and singing karaoke after work.” The myth of Japanese management has been shattered. To understand why, let’s look at Toyota’s kanban system, which was once made so much of in America.

The kanban system is, of course, a superbly efficient technique for minimizing inventory. If future demand were predictable, it would be possible to keep inventory to a minimum and supply only what is needed when it is needed—just in time. Since future demand cannot be perfectly predicted, however, there are two methods for dealing with it. The first is stockpiling finished goods—making what is necessary in advance and storing it in a warehouse until it is needed. The second is to assemble raw materials and whatever else is necessary and be fully prepared to respond instantly and make the required parts. If the latter method is completely implemented, inventory is reduced to zero because parts are considered to be inventory but raw materials are not. As a rule, three factor inputs must be kept in a state of readiness to make the system work: a labor force, capital, and raw materials. If all these can be kept on standby, goods can be made at any time.

Keeping labor on standby is difficult. Even a com-
pany like Toyota does not have the personnel to create a permanent standby unit. This is where the subcontractor and the sub-subcontractor come in. With a single telephone call from Toyota, the subcontractor and sub-subcontractor spring into action. The result is the "just-in-time" production system, that is, making only what will be sold at the time of the sale. In an extreme case, Toyota might put out an order for a 6:00 A.M. delivery at 6:00 P.M. or even 10:00 P.M. the night before, and the subcontractors and sub-subcontractors would have to work through the night to meet the deadline. Thus, Toyota is able to get the parts it wants, and only the parts it wants, when it wants them. This is possible because it has subcontractors and sub-subcontractors waiting on standby. These are the people who bear the brunt of the just-in-time system.

As an American commentator once noted, just-in-time is a system that could exist only in Japan. No matter how much the just-in-time method increases economic efficiency, introducing it into the United States would be impossible. What would happen if someone tried to place an order for a job at 6:00 P.M. on a Saturday or Sunday evening? The worker would say, "What time do you think it is?" and hang up. The just-in-time method is only possible if the social climate is suited to the kanban system, a social climate in which the weak can always be expected to work themselves to the bone at the request of the strong. This is an impossible demand to make in America. At first Americans thought the Toyota system was some sort of magic. But as Paul Samuelson once remarked to me, the Japanese are not gods; they do not know whether demand for cars will go up or down. Once Americans
realized that the just-in-time method was not based on perfect predictions of future demand, but that it worked at the expense of the weak, the *kanban* system quickly lost its appeal.

When some of the glitter wore off Japanese management, questions also arose about Japan as a society that prized efficiency above all else and about whether personal happiness was being sacrificed to achieve it. In Western thinking, efficiency is not a moral value. Although it does not have negative connotations, Westerners do not believe that it takes precedence over everything else. Thus, Japanese-style efficiency is not a universal value and the means required to achieve it can even run counter to the values of Western society.

Ironically, the special characteristics that Japanese self-confidently believe are the motivating forces behind the miraculous growth of the Japanese economy are singled out by Westerners as unfair, inhuman, and not universally valid. Japanese, for example, take justifiable pride in the Shinkansen Bullet train because it is safe, comfortable, and always on time. It is the visible embodiment of Japanese perfectionism, their tendency to put 120 percent effort into everything they do. But, then, Japan's entire transportation system, right down to the old trains in the remote countryside, generally runs on time. There are few countries in the world where you can literally set your clock by the regularly scheduled trains. The quality of Japan’s train service is certainly something to be proud of, but the downside of this Japanese obsession with punctuality may well lead to such inhuman behavior as that of the teacher at a Hyogo Prefecture high school who in the summer of 1990 automatically shut the school gates at the sound
of the bell and killed a student as she tried to enter. If punctuality is given precedence over everything else, discretion and good judgment are lost. This is a peculiarity of the Japanese that Americans cannot understand.

Schools are not the only Japanese institutions that do not tolerate lateness. American young people who have worked as trainees for Japanese corporations cannot understand why Japanese office workers are almost excessively punctual, arriving at work on time only to sit around drinking tea and reading the paper once they are there. This is one example of how rules and authority are given precedence over all other considerations, but there are many others. Americans are at first impressed but subsequently repelled by Japanese pedestrians’ absolute obedience to traffic signals. A lone pedestrian will stand waiting at an intersection for the light to change even when there are no cars in sight. “Why not install traffic lights that can be controlled by push-buttons depending on the time of day?” they will say. “Crossing the street when you know it is safe to do so is common sense by U.S. thinking, even if the light is red. For a woman alone late at night it can even be dangerous to wait for the light to change.”

One of the reasons Americans say Japanese democracy is odd is that it tends to be too efficient. Adopting a single industrial policy, for example, is efficient. First, high-level bureaucrats devise a plan, to which no one makes any objections. Why not? Because the plan is absolutely correct. Why is it correct? Because every aspect of it has the clear objective of achieving the number one position. Devising the best and most efficient means to implement the plan comes next. Once
the details have been worked out, orders immediately trickle down from above. This American view of Japan underlies the revisionists’ argument that Japan is different. This efficient system has nothing democratic about it, they complain; it is totalitarian.

Looked at from this perspective, Japanese democracy certainly does seem odd. It certainly does seem to operate at the expense of “life, liberty, and the pursuit of happiness.” Western-style democracies are, in fact, more inefficient social systems than democracy in Japan. They operate on the principle that a society that functions under the command of a king or a feudal lord may be efficient, but when it comes to the greatest good of the greatest number, one would have to choose democracy no matter how inefficient it is. For the sake of this principle the heads of kings have rolled and the blood of many citizens has been spilled.

The tragedy at the Hyogo Prefecture high school was given a great deal of coverage by the Japanese mass media during the summer of 1990. One commentator made the statement that the incident was proof that there was no relationship of trust between student and school. That someone in a position to have his opinions broadcast throughout Japan could be so obtuse infuriates me. Few seem to realize that the school gate incident, observance of traffic lights, punctual trains, and workaholics living in rabbit hutches are all bound together by a single thread. The power of organizations such as schools or corporations is so great in Japan that they take precedence over everything else. Setting aside the question of whether or not a me-centered society like the West’s is ideal, a value system that puts the priorities of organizations ahead of human needs
will continue to come in for strong criticism from the rest of the world in the years ahead.

**Japan Is the Land of the Leveraged Buyout (LBO).** A prime example of the management practices that America is now reevaluating is the Japanese system of cross-shareholding, which was raised as an issue in the Structural Impediments Initiative talks. America is obsessed with this issue because although Japanese can freely buy almost any U.S. company they want, the cross-shareholding system prevents Americans from buying Japanese companies.

The leveraged buyout is a widespread practice in the United States. Simply put, an LBO turns a public company into a private company. Suppose, for example, that I buy up all of General Motor's stocks and make it into my own privately owned corporation. To do that I would need an enormous amount of money, which I would borrow from a bank using as collateral General Motor's factories which I one day expect to own. The difference between a leveraged buyout and a merger and acquisition is that an LBO makes all the stock in a company someone's private property, thereby removing the stock from public sale and converting a company listed on the stock exchange into an unlisted company. In a merger and acquisition the company being bought becomes part of the purchaser's company, or a subsidiary, or a separate company, but it does not become private.

LBOs have been popular in the United States because in some instances the benefits of being a private company outweigh those of being a public one. The public stock system was developed to allow industrial-
ists to accumulate capital at low risk. The original idea behind the stock market system was to diversify the risk by offering stocks widely for public sale. In other words, if a loss is incurred, each stockholder theoretically suffers only a small loss. On that score, an LBO is extremely risky except when it involves a company with a healthy cash flow. A company with an easy liquidity position is strong.

In 1988, after the management of R.J.R. Nabisco announced its intention to attempt a leveraged buyout, Kohlberg, Kravis, Roberts and Company, a large holding company, launched one instead. R.J.R. Nabisco had been formed by the merger of a tobacco company, R.J. Reynolds Industries, and a cookie-making company, Nabisco Brands. The merger of these two totally unrelated companies was motivated by the fact that tobacco is regarded as a social evil in America and has a bad image. If a tobacco company also made a family-oriented product that everyone likes such as cookies, it would improve its corporate image. The merger resulted in enormous growth for R.J.R. Nabisco, the reasons for which are not hard to understand. Tobacco may be considered a social evil, but once people start smoking they find it hard to quit. Thus tobacco sells well. Cookies are a recession-proof product that sells no matter how badly the economy does. The combination of these two companies produced a bulging cash flow, which was an enormous attraction for others. The inevitable happened—Kravis launched a leveraged buyout.

The advantages of a leveraged buyout are that, as both proprietor and sole shareholder, one does not have to worry about getting fired or about outsiders
attempting a takeover through a merger and acquisition. The proprietor does not have to pay out a lot of dividends because he, not the shareholders, owns the company. This allows him to think about keeping his employees happy and makes possible stable, long-term management. If there is any cause for concern, it is the fact that the risks are not diversified, but as long as the cash flow continues, there is no need to worry.

In the United States, where M&As happen all the time, corporate executives are always anxious about the possibility of a takeover. Every morning American CEOs are riveted to their computer screens, analyzing the latest data on their companies' performance. If stock prices go down, they worry about an M&A, and they always keep an eye out for any large purchases of their companies’ stock. Although CEOs earn high salaries, the pressure on them is enormous. The leveraged buyout was developed to counter M&As. The logic behind the LBO is simple: A public company can become the target of an M&A; if a company is private, there is absolutely no such worry.

Japan's cross-shareholding system is an indirect form of leveraged buyout. In Japan only 20 or 30 percent of a company's stock is actually traded; the remaining 70 or 80 percent is held by the owner of the company or by affiliated banks, insurance companies, and big businesses referred to as “stable stockholders.” American commentators often use the Japanese word *keiretsu* to describe this system of joint stockholding between companies and their main banks and other companies they do business with. The creation of these corporate groupings means that member companies do not have to go outside the group to procure parts
or financing or technological assistance. As in other Japanese groups, the keiretsu has a vertical hierarchy and the parent company has a privileged position vis-à-vis its subsidiaries and subcontractors. This sort of group relationship among companies has many advantages, as some American firms have begun to realize. As long as it does not interfere with a company’s freedom of action, it enables group members to wield considerable power in terms of efficiency, stability, and cost reduction.

Cross-shareholding within a corporate group is a way for member companies to hold stock in one another’s firms to prevent them from going on the market. It was created because at one time takeovers and attempts to buy controlling interests in companies were also commonplace in Japan. Something had to be done to limit the circulation of a company’s stock. Under Japanese law it is illegal to hold stock in one’s own company, so cross-shareholding was devised as a last resort. In effect, one company president says to another, “If you hold 20 percent of the shares in my company, I’ll hold 20 percent of the shares in yours.” If several companies hold each other’s stocks in this way, a group of stable stockholders is soon created, all of whom abide by the unwritten law that no one will sell another company’s stock for speculation. The fact that the stock cannot be sold has the same effect as the company’s holding the stock itself. Because shares are held in the names of the stable stockholders, the law is not violated, but management is in effect holding 70 or 80 percent of its own company’s stock. Cross-shareholding has practically all the advantages of an
LBO: An American-style merger and acquisition is out of the question.

Cross-shareholding Is the Reason for Japan’s High Stock Prices. The excessively high price of stocks in Japan in the late 1980s was a direct result of the cross-shareholding system. If only 20 or 30 percent of a company’s stock ever comes onto the market, this inadequate supply naturally pushes up the price. Because of these high prices, the common international yardstick, the price/earnings ratio, was excessively high in Japan, and nowhere else. This again feeds the Japan-is-different argument.

Additionally, because management is in effect holding 70 or 80 percent of the stock in its own company, there is no need, as there is in the United States, to worry about stockholders. Thus, dividends can be kept low. By holding stock dividends to moderate levels, management can keep its employees happy and adopt long-term strategies—“look ten years ahead,” as Akio Morita puts it. This is impossible in America. A listed company in America puts nearly 80 percent of its stock on the market for public sale, and this stock constantly changes hands. That means that U.S. executives cannot ignore the wishes of their stockholders. They must raise performance levels and increase dividends because American stockholders will not wait patiently for results. If corporate performance deteriorates, the CEO is soon fired.

Japanese executives are critical of American business people for looking only “ten minutes ahead.” It is not a matter of not looking ahead, however, but of not
being able to look ahead. This is the true nature of the stock market system. Japanese companies are proud of their long-term, stable management, but from a Western perspective, this is possible only because Japanese companies are, in effect, private companies.

In *The Japan That Can Say “No”* Chairman Morita wrote the following:

When our factory in California started in 1972, it employed about two hundred and fifty local people. Then the oil shock happened in 1973, and business conditions deteriorated for companies throughout the world. The California plant was hard hit. There was not enough work to keep two hundred and fifty employees busy full time. The president of Sony America, an American, came to me and said that there was no way out except layoffs. But I said “no.” We hired these people, and we are going to keep them; we’ll send money from the parent company to keep all two hundred and fifty of them. If we can’t maintain a daily production schedule, we will use the remaining time for training. The employees were very enthusiastic about this idea. They came to feel that the plant was their home, and they did what American employees never do—they kept their work stations cleaned and polished. This became the nucleus of our California plant. Today, it has about 1,500 employees, and they have never tried to form a union.

Sony was able to avoid layoffs because, in essence, it is a private company. American executives would like to treat their employees well and would not resort to layoffs if they could avoid them. If corporate performance deteriorates, however, and the stockholders get angry and withdraw their money, what else can they do? The very survival of the company is at stake. They may lose everything. That is why they treat stockholders with more consideration than employees.
The United States put Japan's cross-shareholding system on the agenda of the Structural Impediments Initiative talks not simply because American companies cannot buy Japanese companies, but because Americans believe that, by allowing the trading of stocks between companies or groups of companies, Japan is supporting a boycott against America. Cross holding stock for the sake of long-term, stable management is not an internationally accepted practice. America contends that it is unfair because it applies only to business deals within Japan and deviates from the fundamental principles of capitalism.

Japan: The Bubble Superpower

What's Fair in Japan Is Unfair in the Rest of the World. U.S.—Japanese economic disputes surfaced in earnest in the early 1980s. Although criticized for its piecemeal response to American demands, which has been likened to the peeling of an onion, Japan has been slowly instituting reforms. Japan's market today should be approaching the standards desired by the United States and Europe, and foreign criticisms should be abating. In fact, however, foreign criticisms seem to be growing more intense: Japan's rules are unfair; Japan is a closed society. Japan-bashing in America has been gearing up instead of slowing down. Why is Japan the object of so much criticism?

The differences between the United States with its two-hundred-year history and Japan with its two-thousand-year history underlie the economic friction between the two countries. One of the major themes of
American history is the filling up of open spaces. American history is one of nation-building and entrepreneurship—the pioneering of the vast American continent from coast to coast and the invention of new technologies and new types of business. One might say it is a story of economic prosperity attained through the conquest of nature.

This achievement required an enormous population. That is why the population of the United States rose, in seventy-five years' time, from 100 million in 1917 to nearly 250 million today; that is also why the country has become a "salad bowl." To fill up all its open spaces, America opened itself up to immigrants of all races and nationalities. As we've already seen, governing such a country requires a clear and fair set of rules. America's concern with fair rules is the result of the principles on which it was founded.

Japan's history, on the other hand, is that of a closed society on a small island that for the past two thousand years has tried to keep outsiders out. Japan might be called a nepotistic society where regional or family ties enter into all considerations, and where people from the same town or graduates of the same school are given preferential treatment. In Japanese government agencies and major corporations, for example, an "old boy" network of graduates from each of the leading universities is at work to ensure that alumni from their school get promoted. If we look at today's U.S.—Japan trade disputes from this perspective, we might say they are the result of a collision between a traditionally closed society and a traditionally open one. Japan needs to understand that America's talk about unfair rules is rooted in the American frontier spirit and dates
back to a time when, in order to fill up the open spaces—both literal and figurative—of a new society on a new continent, the rules had to be simple, clear, and broadly based, with the details to be filled in later. Until Japan understands this fact, U.S.–Japan relations will continue to go nowhere.

For the most part, Japanese are surprisingly ignorant or, even worse, indifferent about America. Most seemingly informed discussions of America are simply a repetition of preconceived ideas without regard to detail. The criticism that U.S. management looks only ten minutes ahead is an example of this lack of understanding. Relationships in an open society are, by their very nature, short-term and fluctuating. If an American worker discovers that another firm offers better benefits, he or she will think nothing of quitting and accepting the better job. This is normal and natural in an open society. The ability of people to move around freely helps to create a rational, unsentimental society unfettered by any ties. That is how the vast, open spaces are filled in. That is why Shane, in the movie of that name, will never come back but must move on to some new open space. If Shane stayed on and became the town sheriff, he would lose his mythic significance.

Japan is just the opposite. The strong group ties of the Japanese have often been traced back to the days when Japan was a country of rice farmers. Wet-field rice cultivation is highly dependent on the cooperative efforts of the entire community. Japan is a society where relationships of trust can be established only on the assumption that they will continue for a long time to come. Computer companies make ridiculously low bids for new contracts in the knowledge that once a
contract has been won it will be profitable for the long term. Lifetime employment is another example of this way of thinking. Long-term, unchanging relationships are the props that support Japanese society.

The reason for this emphasis on taking a long-term view is that Japan does not have the open spaces America does. Japan is a country with a high arrest rate. This fact, too, is related to its being a closed society. In a society that operates on the principle of keeping outsiders out, criminals have no place to run to and are soon caught. America, on the other hand, offers open spaces even to its criminals. If a criminal in Massachusetts flees to neighboring Rhode Island, for example, the Massachusetts police cannot cross the state line to apprehend him. That is why American law enforcement agencies have a double structure involving state and local police, on the one hand, and the Federal Bureau of Investigation, on the other. In order to maintain an open society, one must be willing to pay the commensurate costs.

From the American perspective, Japan's long-term relationships appear to be designed to exclude outsiders. Americans regard it as normal for a company to conclude a contract with a French company one day, but if a Japanese firm comes along the next day with a better product, to switch over to the company that offers the better goods. This very trait, in fact, has allowed Japan to conquer the U.S. market. Japanese relations, built on long-term trust, are not so flexible. No matter how good an American product may be, an American company will probably not gets its foot in the door because the Japanese distributor has a long-standing relation with Matsushita or some other Japa-
nese firm. To add insult to injury, the American company may be given the useless advice that “if you want to do business in Japan, you must first build up personal relationships. Trust is something that develops slowly over time.”

The Japanese attitude toward relationships is the direct opposite of the American attitude. While it is true that the United States is able to think only ten minutes ahead and Japan thinks ten years ahead, this very fact could be used as proof of the impermeability and exclusivity of Japan, which will use the ten years to establish a monopolistic relationship and make it impossible for newcomers to get in, no matter how hard they try. What could be better proof of this than the revelation in the fall of 1989 that two Japanese computer firms were being investigated for making “one-yen bids” (in one case, the figure was later revised to 1.45 million yen) to secure highly profitable contracts for prefectural computer systems. The lesson this incident teaches is that a long-term, monopolistic contract is far more advantageous than immediate profits. Taking a short-term loss to secure a long-term profit is regarded as natural in Japan, but Americans regard it as a prime example of unfair Japanese business practices.

I was once consulted by an executive of an American insurance company that wanted to branch out into Japan. “We have developed a new insurance product,” he told me, “but when we approached the Japanese Ministry of Finance about selling it in Japan, we were refused permission on the grounds that the insurance was totally new, and thus it was unfair to the other insurance companies in Japan that had no knowledge of the product. If we wanted to sell in Japan, we would
have to reveal the entire nature of the insurance to Japanese insurance companies. Once all companies were able to start at the same point it would be fair, and it would be possible for us to get permission. How can a country like this call itself a free economy that believes in the principles of competition?"

The insurance company executive's surprise and consternation were obvious. In the United States, the government will approve any new product as long as it poses no danger and its purposes are not antisocial. The first company that can get that product onto the market will naturally prevail. The insurance company, which had made a substantial effort to come up with a new idea, was naturally disconcerted to be told that its product would have to be made available to rival companies. This episode clearly demonstrates the difference in business practices between the two countries. Americans find it inconceivable that producers are more highly regarded than consumers in Japan and that companies are asked to reveal the know-how they have gone to great lengths to develop. These attitudes are regarded as antithetical to the competitive principles of a capitalist economy.

To my regret, I had to say to the insurance executive: "I am sorry, but there is nothing I can do. The Japanese authorities ignore consumers and protect producers. They line up all the corporations in a particular sector at the starting line and say, 'Ready, go.' The authorities' responsibility is getting everyone to the starting line. If companies drop out afterwards, it is not their responsibility. But if they don't get everyone off to the same start and a serious problem arises in the future, the official in charge will be held responsible." It is not
without cause that America pushed the interests of the consumer to the forefront of the Structural Impediments Initiative talks.

*The Mystery of Japanese Stock Inflation.* The phrase “stock economy” became popular in Japan in the late 1980s to describe a type of economy in which the growth of asset prices is greater than the growth of the GNP. Although it was certainly possible to describe the Japanese economy in that way, what actually happened was the formation of an asset bubble, that is, “stock inflation.” During the 1980s stock inflation occurred in the United States, too, but the pace was incomparably slower than in Japan. Although Japanese assets increased in value, the development of an excessive asset bubble that threatened to destroy the balance with the GNP was by no means desirable.

In general, when the word *inflation* is used in newspapers and elsewhere, it refers to “flow inflation,” that is, the inflation in the cost of consumer goods and capital goods that most closely affect our everyday lives. The word *stock* refers to land, stocks, bonds, and other assets that will not disappear within a year. If, as the word implies, *flow* refers to things like water that disappear, *stock* can be likened to a river bed. When inflation occurs in stock, it also occurs in flow, which derives from stock. For example, if the price of land rises, the price of condominiums and the rent on apartments built on the land go up as well. In the case of Japan’s stock inflation, however, this did not happen. Although the land in and around Tokyo nearly doubled in value between 1985 and 1989, housing prices did not double.
This was not necessarily a bad thing, but we need to consider the reasons for it.

But first, why did land prices skyrocket in a matter of a very few years? Half of the reason lies with Japan and half with the United States. To be specific, America imports too much from Japan and Japan exports too much. As a result, Japan acquired an enormous reserve and this led to excess liquidity. When a huge trade surplus continued for several years in the 1980s, more dollars entered Japan than could possibly be spent. Of course, Japan could put the money into dollar savings accounts or buy U.S. treasury bills, but it was impossible to use up all the dollars it had earned. Japan, therefore, converted them to yen and was still glutted with money.

America went on printing dollars and buying Japanese goods and Japan kept on selling goods. As a result, dollars flooded uncontrollably into Japan. If the Japanese economy worked the way the textbooks say it should, Japan ought to have experienced severe inflation as a result of this excessive liquidity, but that did not happen because Japan is a country where the propensity to save is exceptionally strong and consumer spending, especially spending on imports, is exceptionally weak. If the money glut did not go into consumption, where did it go? The answer is: into buying land and stocks in Japan and land and companies abroad. This is why between 1985 and 1990 Japanese land and stock prices soared. This situation is what I call "stock inflation" or "asset price inflation," but for some reason people in Japan avoided using the word "inflation" and talked instead about "entering the age of a stock economy" or of Japan as a "stock superpower." This
was glossing over an unhealthy and unbalanced condition. As long as the Japanese government chose to emphasize a way of looking at the situation that conveyed only half the truth, it was not able to make the Japanese people aware of the seriousness of the problem or prepare them for the rapid disinflation Japan experienced when the bubble finally burst.

When applied to daily consumption, the word “inflation” has a very bad image. But when inflation occurs in land and stocks, since these are not essentials of daily life, the people who do not own them are indifferent and those who do become very rich. Although what happened in Japan in the late 1980s was stock inflation, it was inflation nonetheless. The disparity between the have and the have-nots that it created provoked a hard-to-dispel sense of poverty and dissatisfaction among middle managers who were in the prime of their working careers. Ninety-nine percent of the individuals who own land, however, do not use it for business purposes or for speculation. They neither buy nor sell.

Most Japanese cannot sell their land, no matter how high the price goes. If they sold, they would have nowhere to live. Selling one’s land would be as unwise as selling one’s loincloth (fundoshi). Although it is theoretically possible to have several loincloths, the ordinary person has only one so he sets great value on it. When the value of land goes up, exactly the same reasoning applies, but few ever think in these terms. On the contrary, people are delighted because they think, “My land has gone up in value. I could not buy it now. I bought at a good time.” But if they do not sell, no matter how much the value has increased, nothing
else has really changed. Even if they do sell and get a high price for their land, it will cost them even more to buy an equivalent piece of property. There are taxes when they sell and taxes when they buy, and their real estate tax will go up, so there are no advantages in selling. But as long as the asset bubble lasts, landowners feel that they have become rich. That is the illusion of stock inflation. That is also why stock inflation does not spread to consumer goods, that is, to flow.

The vast majority of Japan’s Liberal Democratic party supporters have splendid loincloths, so if the politicians had tinkered with the existing real estate laws, they would have lost votes. Although they had adopted policies that caused land prices to double in a mere two or three years, politicians were unable to devise any appropriate measures to cope with the situation. The Liberal Democratic party kept saying that something should be done about land prices, but, in fact, it did nothing because so many of its members thought they had good loincloths. Moreover, if the price of land were to go down, the big banks that provided the financing would be seriously affected, as in fact they have been.

_The “New Rich” Phenomenon._ This sort of situation cannot last for very long, however. As often happens in economics, if an imbalance occurs, there is inevitably a movement to correct it. Just as it is impossible to eat too much rich food without suffering a weight gain or even developing cirrhosis of the liver, it is impossible for stock and only stock to become excessively inflated. In the normal course of things, something happens to
stop the rise in the price of land and stock market shares.

As a general rule, when the price of land stops rising, the prices of other commodities catch up to restore a balance. Over the years Japan has experienced several periods of runaway inflation in land prices. During the administration of Prime Minister Kakuei Tanaka (1972–1974), the government spent too much money on a plan to “remodel the Japanese archipelago,” a massive public works program aimed at developing the Japanese countryside for industrial expansion. This caused the price of land to shoot up. But eventually the land stopped selling, and the price rise came to a halt. Then, slowly, incomes began to rise until ten or fifteen years later people were able to buy land again. This is the normal pattern that this process follows.

But Japan’s trade surplus has been both huge and long-standing. As a result, the money glut had no place to go and the unprecedented happened: The rise in Tokyo’s land prices spread to the rest of the country. It was as if Japan were suffering from a cancer that metastasized: The body loses its strength and can do nothing but wait to die. Foremost among the signs that this was happening in Japan was what is known as the “new rich” phenomenon, which is fundamentally changing the egalitarian society that Japan has created since the end of the war. Of course, it was a good thing for the people who became more affluent, but it has also enormously magnified the gap in incomes and living standards between those who got rich and those who did not. This definitely cannot be considered a plus for the future vitality of Japan.

Someone once told me an interesting story. In front
of Keio University, one of the top private universities in downtown Tokyo, there used to be an old and rather mediocre sushi shop where many Keio students went to eat cheap sushi. When the price of land went up recently, the sushi shop owner sold the property for several billion yen. He bought a house, a place in the country, and an imported car. In a complete turnabout the owner of a mediocre sushi shop had become a member of the nouveaux riches.

This man's good fortune is a matter for congratulations. The problem lies in the structure of the economy that it reflects. The people who once ate cheap sushi in that shop studied hard and became leaders of Japan's political and financial world. But no matter how hard they work, no matter how great their services to Japan, they will earn only about one or two hundred million yen in their lifetimes. Half of that will be taken up by taxes, and when they retire, it is doubtful that they will have a hundred million yen left. To cite a pun making the rounds, in Tokyo you can't buy a mansion for that kind of money, let alone an oku-sion.*

When the new rich phenomenon occurs, talented people who have a real contribution to make to Japan lose the will to work. Until recently all Japanese claimed to belong to the middle class. When they looked at their neighbors and saw there was not too much difference between them, they were willing to work just a little bit harder in the belief that they could get ahead. It became a point of pride when Japan was

*Mansion is the Japanese term for a condominium. Oku-sion is an invented word. The pun plays on the word man (in mansion), which means ten thousand in Japanese, and oku, which means hundred million.
called an economic superpower, and when Japanese heard that an American white-collar worker owned a house with a swimming pool, it did not mean much and no one felt jealous. Popular comparisons that likened Americans to the proverbial spendthrift grasshopper only served to make them work even harder. But then they saw the people next door sell the tiny strip of land their parents owned in the Tokyo area for several billion yen and become members of the new rich. This is bound to do considerable damage to Japanese morale, to the political base, and to the will to work and is likely to become a serious issue in the future.

For Tokyo residents who own no land, owning a home of their own has become an unattainable dream unless they move far out of the city. They have probably not been sorry to see the price of land plummet in the past two years, but the people who are suffering most during the present disinflationary period are those with low incomes. In the long run, it will be a nearly impossible task to restore the situation to what it once was and eliminate the gap between rich and poor. The very strengths that have made Japan an economic superpower—its Japanese-style fairness and egalitarianism, its skilled and diligent work force—may be lost. The high land prices that made Japan into a global asset-holding superpower also hold this explosive potential at home.

The End of the Bubble Economy

Collapse from Within. On the last trading day of the 1980s, December 29, 1989, the Japanese stock market
stood at 38,915 points. Slightly more than a year and a half later on July 18, 1992, the Nikkei index had plummeted to 14,309 and Japan was headed into recession. It is a truism to say that the present recession in Japan was caused by the end of the bubble economy. The point I would like to make, however, is that a distinction needs to be made between this recession and the ones that have preceded it. Previous recessions have been triggered by some kind of external shock; the present recession was caused by factors within the Japanese economy itself.

The recession of 1971, for example, was caused by the “Nixon shock”—the announcement by President Nixon in 1971 that the dollar would no longer be convertible to gold. At the time the International Monetary Fund was established, the dollar was pegged to gold at a price of thirty-five dollars to the ounce. When America’s balance of payments began to show a deficit and gold flowed out of the country in huge quantities, however, the United States decided to go off the gold standard, thus forcing the revaluation of currencies throughout the world. Japan was particularly affected; with the yen-dollar exchange rate no longer fixed at 360 yen to the dollar, the yen strengthened dramatically with adverse effects on the Japanese economy.

The first oil shock two or three years later dealt the Japanese economy another severe blow, but as we shall see in chapter 6, Japan was not only able to deal successfully with the recession and inflation that resulted from a rise in oil prices, it actually came out the stronger for it. That was certainly the case at the time of the second oil shock in 1979–80 when Japan made use of its earlier experiences to emerge in the 1980s as
a major economic power. The Plaza Accord in 1985 was another externally caused setback, but as I have already discussed in chapter 1, Japan was soon able to overcome the problems caused by the strong yen. In fact, U.S. pressure on Japan to expand domestic demand stimulated the Japanese economy and made it even stronger.

As a result, a bubble economy was created and eventually that bubble burst. Business has deteriorated even for blue chip Japanese companies such as automakers; Nissan, for example, has been forced to close one of its main high-tech factories. Major computer makers and producers of consumer electronics are all suffering, and steel companies have been slashing their work forces. Japan has fallen into a recession of major proportions unlike anything it has experienced in the post-war period. This time, however, the recession was not caused by an external shock but rather by causes within the Japanese economy and thus it is quite different in nature from the recessions that preceded it.

The collapse of the bubble economy has also been accompanied by a series of distinctly Japanese scandals in both the financial and the political worlds. One of the first of these to surface was the revelation that some of Japan's major security companies were compensating favored clients for their investment losses. Here was another blatant example of Japan's hyper-corporatism—the corporate structure that protects large, long-term clients at the expense of the consumer, or in this case, the small investor. More revelations followed—the Sagawa Kyubin kickback scandal, links between government officials, big business, and organized crime, and the arrest of Liberal Democratic
party "fixer" Shin Kanemaru. Cash payments to Japanese politicians are nothing new or, for that matter, newsworthy, but even the most hardened cynics have been astonished at the sums involved in the Kanemaru case. The recent series of scandals has been criticized worldwide and Japanese politics has become an object of derision.

Right now Japanese-style capitalism presents a sorry sight to the world for many reasons. But the United States, Britain, and other countries with advanced capitalist systems have all gone through similar experiences in the early stages of their development. No country has had a textbook-perfect system of capitalism right from the very beginning. In this sense, Japan is not unique. Criticisms of Japan's late-blooming capitalism by mature capitalist countries have been quite severe, but that does not mean that they themselves have never had similar scandals or similar economic bubbles. The U.S. economy has already gone through the experiences that Japan is now facing; it can be compared to a somewhat older graduate of the same school of hard knocks, now older and wiser, who is apt to deny that he might not have always done all the right things himself when he was young.

Japanese-Style Capitalism. To understand how the bubble economy developed in Japan we first need to understand how banks and countries generate money. Some people have suggested that a monetary system in which all business deals are conducted in cash would prevent the risks of a bubble economy. There is a grain of truth in that suggestion. If the money supply was determined by the amount of hard currency a country
had and every time it bought something it would have to draw on its cash reserves, the possibility of a bubble economy developing would be reduced. The problem is that the limited supply of money would make it difficult to build new factories, put in new equipment, or make the other real investments needed to make goods to sell. In short, a monetary system based on hard currency prevents an economy from making adequate use of its productive capacity. That is, in fact, why a gold or silver standard has become obsolete and has been replaced by credit.

Although in the long run, the way capitalism works in the United States and Japan is not very different, there are differences in certain aspects of both systems. One of these areas is the way the two economies expand credit. Japanese-style capitalism is a form of capitalism that might be called an assets or a "land standard" system. In this system, assets come first and banks play the leading role. Banks use assets—primarily land—as collateral to create the credit from which earnings are generated. These earnings are channeled back into greater asset formation, on which the banks once again make huge loans, and this process is the engine that powers the Japanese economy. This type of economic behavior led to rampant asset inflation during the bubble economy period. Land used as security to borrow money created huge quantities of credit, which in turn sent the money supply soaring. Loans in Europe and North America are also backed by mortgages taken out on homes and factories, but no other country in the world uses land as collateral to the extent that Japan does. The enormous money supply created by these land-backed loans sometimes goes into
“flow”—consumer goods and investments—and the result is inflation in the ordinary sense of the word, but in this case it went into the purchase of more assets and the result was an asset bubble and what I have earlier called “stock inflation.”

Lack of resources is of course the conditioning factor behind Japanese-style capitalism. Because Japan has no natural resources of its own, businesses there are of the type that provide goods and services to the consumer. Japanese companies, therefore, must use their assets to create capital, which is then put to work to acquire earnings. In Japan a network of big banks backed by the government (the Bank of Japan and the Ministry of Finance) is spread throughout the country. Because Japanese businesses are run with money borrowed from banks using real estate as collateral, the main bank’s say in the business world is enormous. Furthermore, the fact that the government is behind the big banks’ free creation of credit has given rise to the myth that there can never be a bank failure. Big Japanese-style banks which operate in this manner do not exist in Europe or North America. With a few exceptions, American banks, by comparison, are merely local banks that carry on small-scale financing. In resource-rich America the capital that is highly valued is not assets but working capital and there is little need for real-estate-secured bank borrowing. The political and economic climate does not allow for the creation of big banks on a Japanese scale, and banks do not have the same kind of status that they do in Japan.

*Land and the Bubble Economy*. The end of the bubble economy finally laid to rest the myth that the price of
stocks and other assets may go down but the price of land in Japan will always go up. The reason the present recession is fundamentally different from earlier recessions caused by external shocks is that this time the value of land in some areas has fallen by 20 to 30 percent. As we have seen, Prime Minister Tanaka’s plans to remodel the Japanese archipelago also caused land prices to soar in the early 1970s. When that bubble burst, land stopped selling but its value did not go down to the extent that it has today. The rise in land prices came to a halt, real estate stopped selling, and over time both income and earnings slowly went up so that ten years later the balance was restored. Then, asset prices began to rise once again, land began to be sold, and the economy prospered.

When an economy is running smoothly, the ratio of income to assets remains constant. This is what Professor Paul Samuelson and I call the “law of economic conservation.” In the case of the American economy, the ratio of GNP or GDP to total assets or total wealth between 1950 and 1990 has been 0.33. To put it another way, in the United States three units of assets are required to generate one unit of income. This ratio of 3 to 1 has continued almost unchanged since World War II, through the so-called golden age of the 1960s, the post-Vietnam period of high inflation, the soaring asset prices of the 1970s, and the oil shocks at the beginning of the 1980s. Deviations from this 0.33 average have been very slight.

Although a comparison of the earnings to assets ratios for all the OECD countries has not yet been completed, the figures for Canada are nearly the same as those for the United States. They fluctuate between
0.33 and 0.29 with an average of 0.31. Even for Britain, the rate between 1950 and 1990 is in the range of 0.25.

If we look at trends in the ratio of GNP to total wealth in Japan, however, the situation changes dramatically. The figures go from 0.255 in 1955 to 0.247 in 1970 and finally to 0.179 in 1991; in other words, the average rate of return on assets has declined to almost 12 percent. Compared with America, where a stable rate of return on assets of around 30 percent has always been maintained, this figure is astonishingly low and shows the extremely unstable and fragile side of the Japanese economy, which is normally believed to be so robust. Indeed, in this area there is a fundamental difference between Japanese capitalism and the capitalism practiced in the industrialized countries of Europe and North America.

As long as assets in Japan play the role they do, Japanese capitalism will probably continue to be asset-oriented, but when the return on assets becomes as excessively low as it did at the height of the bubble economy, reason will dictate an economic correction. The crash of the stock market should be seen as an adjustment to Japan’s unbalanced earnings to assets ratio.

In the past the mechanisms to bring earnings in line with assets were quite different from what has happened in the past two or three years. Until now the pattern had been that first real estate values went up, then after a while they stopped rising and waited for earnings to catch up. This time, however, because the rise in asset prices was too steep for earnings to be able to catch up, prices began to come down of their own accord.
In any event the bubble economy has come to an end, and the Japanese economy, like the European and American economies, now has to deal with an internally generated boom-and-bust cycle. Banks are tottering, brokerages are going bankrupt, even Japan’s strongest manufacturing companies are going through hard times. Perhaps the economy will improve only to slip back into recession again, but ultimately the economy will prosper. Capitalism has its periods of prosperity and recession. During the boom periods some people become enormously rich; when the boom comes to an end some go bankrupt. Just as people go through many ups and downs in the course of their lives so do businesses, but in the long run the economy as a whole improves. That is what the capitalist system is all about. Some may wonder whether it would be more efficient to plan everything and make the economy run according to plan instead of having a market-oriented system. Economies based on plans made by fallible human beings may at first seem to run smoothly but the collapse of socialism in Eastern Europe and the Soviet Union has shown that they are in fact even more fragile than economies that are left to the workings of market forces.

The failures of an economy simply prove that human beings are not perfect. Everyone makes mistakes. Companies, like people, try various things and sometimes they fail, but they make use of what they learn from their experiences and try again.