Business and Financial Conditions

The present cyclical upswing, dating from late spring, is featured by an oddity not present at the comparable stage of the previous five postwar recoveries. The oddity is this: while virtually every new statistic demonstrates that the recovery is more vigorous than most analysts expected a short time ago, there is considerable agonizing over the possibility that before long the upswing may fizzle.

Worry about inflation is the basic cause of that concern. To be sure, the sharp diminution in the rate of advance of consumer prices in August has eased the worry temporarily, but the shock of double-digit inflation rates in June and July has by no means fully worn off. And it is not likely to until such time as further evidence justifies the conclusion that the June-July experience was indeed an aberration. The reason the inflation trend is so critical, of course, is that, by common agreement, it was the earlier severe inflation—more than any other factor—that produced the recession from which the economy is now emerging.

For the moment at least, few analysts would deny that the business trend is strongly up-beat. Confirmatory evidence can be found on all sides: August's fast climb in industrial production (the biggest rise in nearly three years); the August bulge in personal income; solid improvement in labor markets (an increase of 1.5 million jobs since March coincident with expansion of the work week by a full hour); and the impressive performance being shown by the composite of leading business indicators (up more on a percentage basis in the five months since the composite bottomed than in the comparable span of any earlier
A Key Element in Japan's Economic Policy

Economic policy in Japan has been quite different in many respects from that in other developed countries. The following article describes one significant difference. It was written by William V. Rapp, a banking officer in Morgan Guaranty Trust Company's Tokyo branch and formerly an economist with the Agency for International Development in the Far East.

The Japanese economy has had to cope with a number of major shocks since 1971: a 20% appreciation of the yen against the dollar, a quintupling of oil prices, a severe inflation, and a worldwide recession. These have occurred, moreover, against a backdrop of increasing Japanese concern about environmental pollution, the quality of life, and the merits of traditional growth-oriented policies.

A consequence of these shocks has been the first Japanese recession of the postwar period and a drop in industrial production roughly comparable in degree to that in the United States. Further, employment conditions have deteriorated to the extent that a labor shortage has become a labor surplus, and unemployment is running over one million people or about 2% of the labor force. In short, Japan has been experiencing unaccustomed economic difficulties.

On the whole, however, the succession of shocks has caused less disruption and hardship than might have been expected. In particular, Japan has confounded critics who had warned that Japanese companies would experience extreme difficulties—because of their permanent employment commitments and their high levels of debt—if the growth spiral were interrupted. To be sure, a number of bankruptcies have occurred and others may yet lie ahead. But the toll has been less severe than some had feared it would be.

Meanwhile, the point of maximum stress for the economy at large seems to have passed, especially since the supply of oil upon which Japan depends for 70% of her energy has continued uninterrupted. The Japanese economy is now showing signs of recovery, and "real" growth is a strong prospect for the second half of this fiscal year (October 1, 1975 to March 31, 1976). Importantly, such growth will occur in a healthier setting than existed a year ago. Inflation is still a problem, but Japan has made significant progress in moderating the rate of price increase and in damping her wage spiral. Wage settlements for major industries during this year's "spring offensive" averaged 10% to 15%, compared with 30% to 35% last year.

Japan's payments position, moreover, has evolved in an encouraging manner considering the enormous rise in foreign-exchange expenditures for petroleum. Despite an oil import bill last year of $21.2 billion (six times that of 1971), Japan has managed to keep her aggregate payments deficit at a reasonable level due to a determined export drive and relatively stable export prices over the last year. With her trade balance firmly in the black since September 1974, the payments outlook is favorable. Meanwhile, although there are many reasons for thinking the economy's average real growth will not resume the remarkable 10% pace that prevailed for fifteen years prior to this recession, pessimism concerning Japan's
resumption of solid growth does not seem justified. Rather, the outlook for the next half decade is for growth well above that in the other developed countries.

How does one explain the striking capacity of the Japanese economy to deal so well with adversity? Some part of the credit obviously lies with well executed monetary and fiscal policies. But besides skilful demand management, another and frequently overlooked set of policies also has been operating. That is, for many years active supply management has imparted to the economy special elements of strength and resilience. In my judgment, this tradition of supply management—invoking the participation of government, business, and labor in efforts to promote the rapid development of industries considered critically important to the Japanese economy—helps significantly in explaining why the Japanese economy has performed as well as it has.

Because of institutional arrangements that are uniquely Japanese, Japan's supply management is quite different from anything occurring in other developed countries.* Its basic strategy has been to stimulate capital-intensive, high-technology industries (e.g., steel, chemicals, automobiles, and computers) while reducing dependence on the traditional labor-intensive sectors. In this way the economy could simultaneously upgrade employment and income levels, deal with growing competition from the less developed countries, and increase its comparative advantage in more advanced industries vis-a-vis other industrialized nations.

Those evergreen loans

The special support given to targeted sectors has involved both protection (shielding infant industries from foreign competition) and various performance incentives (such as rapid depreciation, special tax benefits for exports, and low-cost credit from government banks). It has also entailed very heavy use of commercial banks to finance Japanese firms, with the funds supplied not just for short-term purposes but as a substitute for long-term debt and equity as well. This system has produced extremely high debt levels by U.S. standards and has been possible only because the government in considerable degree has implicitly guaranteed loans to major corporations and has stood ready, through Bank of Japan discounting, to make funds available to banks lending to targeted industries. Japanese banks see themselves as supplying capital to major corporations and generally do not expect repayment on the 90-day terms usually specified in loan agreements. Borrowings carried in bank ledgers as "short-term" are actually "evergreen" loans that are repeatedly rolled over. Since to protect their investments banks in most instances will lend additional funds during periods of inadequate cash flow to help corporations fund their positions, there is a cushion available to firms during economic stress despite their high leverage.

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Supply management's origins are found in Japan's ad hoc and practical response to earlier postwar problems, especially reconstruction and foreign-exchange requirements. Only gradually did supply management become a coherent, interrelated, and mutually reinforcing set of policies and institutions involving government, business, and labor. Initially it logically emphasized a few strategic industries critical to Japan's basic industrial progress (e.g., power, steel, coal, fertilizer, and shipbuilding). The fertilizer industry, for example, was favored in order to increase agricultural productivity, with a view to reducing imports and releasing labor for manufacturing. And shipbuilding was needed to rebuild Japan's merchant fleet and reduce foreign-exchange expenditures. But in time, supply management evolved into a concern with high-technology industries characteristic of advanced industrialization (e.g., automobiles, petrochemicals, electrical machinery, electronics, and computers) and the upgrading of the industrial structure.

Jobs without end

This guided development of supply capabilities is important in explaining the rapid growth of Japan's postwar economy. Support of efficient industries alone would have been a powerful spur to development. But reinforced by Japan's employment and financing systems, such treatment became extremely potent. The permanent employment system has encouraged growth because it gives workers security, thereby minimizing strikes and resistance to innovative job practices. In addition, it has enabled fast-growing firms to benefit competitively from lower average wage costs, because workers are hired directly from school for life and are paid on a seniority basis with little difference in productivity differentials among workers.* The system of bank financing has accentuated growth by allowing corporate expansion to proceed much more rapidly than would have been the case if corporations had been adhering to the kind of debt-equity standards prevalent in the U.S. Further supporting rapid growth has been Japan's high personal savings rate and the government's general adherence to a full-employment budget surplus. A generally liberal monetary policy during periods of expansion has in turn facilitated the flow of personal and public savings to business and into productive industrial development.

The qualitative features of all this have been significant. High growth and productivity usually go together, and this has been true to a remarkable degree in postwar Japan. In turn, rapid productivity gains have permitted relatively aggressive pricing both domestically and in foreign markets, and this ability to price aggressively has been fully exploited because of the built-in need Japanese firms feel to operate at full capacity (given the high fixed costs of permanent employment and heavy indebtedness). Moreover, the market expansion that has flowed from aggressive pricing has caused the whole process to be self-reinforcing. It has generated expanding investment opportunities, greater productivity, growing requirements for new product development, and the need for aggressive pricing to keep expansion going. The persistent Japanese drive for market share both at home and abroad essentially flows from these interrelationships.

The mutual reinforcement of the government's industrial policies, high leverage, the permanent employment system, high invest-

*The significance of this is indicated by the fact that credit analyses of Japanese firms always include information on the average age of the work force.
ment rates, rapid cost reduction, intense market-share competition, aggressive pricing, and rapid product-cycle evolution has been especially noticeable in basic industries like steel, chemicals, shipbuilding, and electrical machinery. It is such industries whose expansion has benefited most from the array of special inducements and competitive pressures that have accompanied supply management. This is mainly because the efficient plant size in major capital-intensive industries has grown substantially in recent years. This has led to very long planning and construction periods and has also meant (especially given inflation) that enormous sums of money have had to be mobilized to create large units of additional capacity. The efficient size of a new steel mill, for instance, is now ten times or more what it was two decades ago, with all-in costs well over $2 billion. The decision to develop such a plant—or to build a modern petrochemical center or aluminum refinery—is thus a major financial and business decision involving a sizable portion of any firm's total resources. In many countries other than Japan, the risks and the capital involved in large projects have seemed so formidable to businesses in recent years that many contemplated projects have not materialized, with the consequence that Japan now enjoys a significant competitive advantage in a number of key industries. This advantage has helped her maintain exports through the current worldwide recession and should continue to do so during the next few years.

In Japan's case, the risks for the typical firm in basic, capital-intensive industries have in fact been in not investing, since a failure to invest could mean falling behind competitors who were likely to respond to the expansionist inducements and pressures of the Japanese system. Moreover, given the fundamental impor-

tance of these industries, the efficiency of the whole economy has been enhanced both by their individual growth patterns and by significant synergies among the different industries that have been favored. A modern, highly efficient merchant fleet, for example, has helped to lower costs for oil, coal, iron ore, and so on, while lower costs for steel and energy have in turn benefited transportation costs.

_Dealing with “excessive competition”_

Progress in any country is, of course, never entirely smooth, and there have been difficulties even in Japan for key industries and firms. But the government's—and the financial community's—assistance is usually available to help major firms and industries through periods of temporary strain. Most conspicuous probably is the assistance rendered when capacity expansion in a particular industry has been so rapid that aggressive price cutting would be counter-productive and self-destructive. To manage such “excessive competition,” the government usually encourages the formation of a temporary price cartel and queues further investment on the basis of existing market shares and future export and domestic-demand projections. Competition is thus stabilized and additional investment is much less risky than it would be without some government monitoring. By contrast, in countries in which governments do not queue investments, or reduce “excessive competition,” or implicitly guarantee substantial bank borrowings, firms are much more likely to develop cautious attitudes toward continued expansion, and particularly toward large-scale investment projects, whenever expected rates of return appear uncertain. This has, in fact, happened in recent years.

Governments in the U.S. and elsewhere not
only are less solicitous of key industries than is the Japanese government, but their actions often are actually inhibiting in their impact. Typically, such governments have tended to shift resources away from investment in basic industry toward the public and consumption sectors. Partly this has been the intentional result of budget decisions; but it has also been the consequence of not adjusting depreciation schedules or other tax regulations for the effects of inflation. The net result has been that non-Japanese firms often find themselves at a competitive disadvantage internationally.

**Emulation not feasible**

In itself this is not an argument for Japanese-style supply management in countries such as the United States. Major differences between Japan and other countries—in political and social values and traditions, in antitrust laws, in financial structures, and in relationships among government, business, and labor—preclude, of course, any literal transplanting of Japanese techniques. But while emulation is not feasible, Japan's success in promoting rapid growth of efficient industries suggests that there may be lessons for other countries in the way in which policy actions affect supply capabilities.

How a tax measure, an expenditure program, or a regulatory step is likely to affect the development of specific industries and the economy's broad supply structure ought to be considered in connection with every important action the government takes. Generally, concern with the encouragement of a rational, efficient supply structure has been absent in most Western nations.

Sometimes, when Western governments have given special support to industries their actions have had the effect of lessening the economy's over-all efficiency. In contrast, Japanese policy has been consistently aimed at reducing the flow of resources to uncompetitive segments of the economy while promoting more advanced sectors.

Japanese success in using supply management to promote economic development does not mean that past policies will continue without change. On the contrary, modifications are now occurring and more can be expected. Significantly, the very success of supply management in contributing to higher incomes and rising expectations has created pressure for change. The Japanese public which for many years has generally supported growth-oriented policies is now clearly re-evaluating its priorities. Demands are mounting for a better life style, a cleaner environment, and more welfare-related programs. This reflects the fact that rapid industrial growth has been achieved at a high cost in terms of pollution, social under-investment, and soaring land prices. The last in particular have generally put private homes out of reach, have made it difficult to increase recreational and other public facilities, and have hindered the rationalization of distribution through larger-scale stores. Social and political dissatisfaction thus has risen along with economic success, and policymakers now see the need for changes in economic policy with more attention to social welfare and correspondingly less to industrial and export expansion.

Actually, Japanese policymakers have been seriously discussing reorientation of the nation's economic goals since 1970. Considerable thought has been given to the desirability of upgrading the economy by shifting expansion away from basic industry toward cleaner, knowledge-intensive industries. Companion action would encourage those industries which
pollute to stabilize or reduce domestic production and to carry on further expansion offshore. Additionally, the government would significantly enlarge social-overhead expenditures. While a consensus was reached on such an approach, various constraints have forced a rethinking of practicalities. (Included among the constraints are stiff foreign competition in newly targeted industries, balance-of-payments pressures, growing nationalism in many countries with respect to projects entailing environmental risk or raw-material exploitation, and increased international political and economic uncertainties.)

What seems a likely result is an upgrading of the economy primarily via qualitative improvement in the existing supply structure. That is, the emphasis probably will be on upgrading the technology of Japan's materials processing and machinery industries. That would entail de-emphasis of first-stage materials processing operations, with progressive movement into more sophisticated fabrication and engineering. This would be accompanied by increasing efforts to decrease the adverse environmental impacts of all production operations. To whatever extent proves feasible, first-stage materials processing would gradually be moved offshore, with Japanese firms importing and fabricating the output. By this approach, Japan would use and maintain her current economic strengths, while managing a gradual transition to a cleaner and higher-quality industrial environment. Coincidentally, a shift toward more emphasis on consumption is likely, especially in terms of increased social-welfare expenditures by the government.

It is hard to forecast the consequences of these developments in the Japanese economy. The over-all growth rate almost certainly will be lower than it has been in past years, but it would be a mistake to underestimate Japan's ability to maximize its potential, especially as savings and investment rates probably will remain high. Japan's unique system of supply management, meanwhile, is likely to continue as an important conditioner of her economic development.