



## Japan's Third Way: A Public Intellectual Confronts Japan's Economic Stagnation

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#### 1. Economic Stagnation and the Safety Net

Kaneko Masaru is one of Japan's best-known students of the country's crisis-ridden political economy and public finances. He is also a very prolific public intellectual. Over the past five years, he has authored or co-authored over 20 books, co-edited six, and written dozens of articles in the monthlies and the press. Kaneko writes in a country still dominated by the absurd notion that American institutions present a "global standard" to be matched lest Japan's decline become permanent. His controversial ideas on fiscal and financial reform are thus often sought out -- often surreptitiously -- by LDP and opposition party politicians and intra-party study groups. He is also a frequent speaker at academic and NGO forums and a high-profile commentator on policy-oriented television and radio programmes. In short, his eminently readable and cogent critiques of contemporary economic policies have earned him a broad professional and popular following. Indeed, his books are frequently displayed in their own sections in Tokyo bookstores.

Kaneko's most recent sole-authored work is *Choki Teitai* (Long-Term Stagnation). Published in August of 2002, it was widely acclaimed and became a bestseller among books in its class. Within two months of its release, the book had sold over 80,000 copies and added an historical perspective to the domestic debate over the causes of Japan's deflationary spiral and the options for countering it. Three years earlier, Kaneko's *Sefutinetto no Seijikeizaigaku* [The Political Economy of the Safety Net] also attracted considerable attention with its boldly reformist challenge to both the immobilist old guard and the "global standards" crowd's neoliberal proposals to privatize risks and rewards.

Several key themes run through virtually all of Kaneko's work, with the tactical focus of his critique shifting according to the policies and proposals of the day. The core theme is the gradual elaboration of a distinctly Japanese-style 3rd Way -- not to be confused with its British namesake propounded by Tony Blair -- toward reforming the role of the state and its relation to the market. Kaneko criticizes the vested interests whose monopolization of the public sector has brought Japan to the brink of ruin. However, he does not simply throw up his hands and suggest leaving as much as possible to the market, as in post-Reagan America. Rather, Kaneko emphasizes the diversity and embeddedness of the fiscal and financial institutions that make up the modern political economy. Kaneko argues that such institutions differ profoundly among countries, in ways that make contemporary Japanese neoliberal efforts to reform on the American free-market model not only unduly idealistic but also potentially quite costly in economic as well as political terms. He stresses the 'lessons of history,' which teach us that in pursuing the rigid orthodoxies of 'deflationary small-statism and deregulation,' policymakers risk inducing a serious and perhaps even catastrophic crisis (1999: 48).

This idea of institutions is, of course, quite different from the more compact concept that dominated the rational-choice school of political economy through much of the 1990s. Rather than a micro-level focus on individuated actors, their incentives and their initiatives, Kaneko's interest tends more towards the meso and macro levels of analysis. This approach emphasizes systems and their interaction with larger contexts and groups, such as workers in general. While the approach lacks the theoretical elegance and precision of micro-level political economy, it encompasses a good deal more of the actual substance of contemporary Japan.

For example, Kaneko has long argued that reform is essential in the network of institutions that compose Japan's woefully inadequate social safety net. So do most other analysts. But they start from a small-state premise, and so restrictively define 'safety net' and the risks it insures against to unemployment benefits and other items related to the labour market. Kaneko's conception of the safety net is much broader and the risks it is to protect against more comprehensive. These risks include not only the possibility of unemployment and impoverishment in old age, but also those engendered through trading in the markets for land and capital. In order to limit or cope with these risks, Kaneko notes, states have long implemented such measures as regulations governing speculation in land and insurance schemes for bank deposits. It is hardly novel to think about these risks and include them in one's conception of economic policy, as they are among the classical concerns of political economy. But in recent years, to ask the state for even a modicum of security from such risks is immediately castigated as 'rent-seeking.'

Kaneko's reformist vision does not look to insure against all the risks associated with capitalism, which would surely result in the 'socialism' for which Japan's political economy is routinely derided. Rather, Kaneko wants to bolster the financing and functions of the large-scale systems within which actors confront and cope with risks of the marketplace and life in general (e.g. sickness and ageing). These reforms include the funding and administration of pensions, inter-governmental relations and other public-sector systems (1999: 58). Kaneko argues that enhancing equity and socializing many of these risks more broadly will facilitate the country's industrial transformation. This is because, he insists, the holes in the current safety net impede labour mobility, restrict consumers' willingness to spend, and hinder the overall political economy's capacity to adjust to changing needs and opportunities. The argument, in short, borrows a little from the neoliberal stress on shifting more of the risks and rewards of the market to individuals. It also draws on the old Left scheme of shielding people from the market by building a bigger state. But then Kaneko leaves both of these approaches behind.

A related focus of Kaneko's concerns is the ominous challenge posed by bad debts, or non-performing loans (NPLs). The NPLs are largely the overhang of debt from the excessive speculation and over-investment of the bubble years. Official estimates of NPLs peg their aggregate total at about 50 trillion yen (U.S. \$470 billion). But Kaneko, like most specialists on Japan's financial markets, suspects that NPLs amount to at least twice that figure. That means NPLs could exceed 20% of Japan's GDP, which is just over 500 trillion yen. One recent estimate by Goldman Sachs even estimated NPLs at approximately 40% of Japan's GDP. Unwilling to decimate the sectors -- especially construction and real estate -- that borrowed most of these debts, the banks and the state have essentially colluded in a scheme to recycle public finance to them and roll over their loans (Jinno and Kaneko 2000: 18). But the scheme effectively subsidizes very inefficient uses of land, labour and capital, and passes on much of the cost to future generations through mounting public debt. And with the banks additionally hemmed in by international rules, such as the Basel Accords, they are wary of increasing their liabilities through new borrowers. This means that new ventures are starved of funds. Small wonder, then, that Japan's NPLs are almost universally given a large part of the blame for a decade of economic growth averaging less than 1% per year in an economy that looks to be heading into its fourth recession since 1990.

Moreover, the crisis in the public finances is indeed grave. As we know, Japan is rapidly ageing. In 2002, 18.5% of Japan's population was

already over 65, compared with 16.4% in Germany, the next highest among the world's five largest economies. Japan should be laying the fiscal groundwork to cope with the inevitable increase in public-sector costs that the ageing of the population will bring. But the country is saddled with an enormous public debt (over 150% of GDP in FY 2003) and chronic deficits (7.7% of GDP in 2003) due to excessive reliance on public works, slow growth, and repeated efforts to stimulate the economy through tax cuts.

The interlocking set of difficulties sketched above would present a daunting enough challenge for any government. But as Kaneko points out, it is not only Japan's tax base and general budget spending that require full-scale reform. The public pension system must also be bolstered, by financing it through the tax system. The present system is funded largely out of contributions, with ad hoc infusions of money from the central government's budget to cover shortfalls or to put off hard choices on reform. But this financing scheme is unsustainable because it covers a shrinking share of the workforce (due especially to the increasing number of part-time workers) and faces the enormous challenge of matching benefits to revenues as the number of recipients climbs even as the working population declines. The failure to undertake serious reform to pensions further depresses consumption and discourages risk-taking as individuals' faith in their own financial future erodes.

These intractable policy conundrums have been furiously debated at home and abroad for some years now, with reform proposals including massive tax cuts, inflation targeting, and other drastic measures. Kaneko summarizes the domestic debate over what to do into two polarized positions. The first looks enviously at the deregulation, privatization and supply-side tax cuts of the Reagan years and afterwards in the United States. This neoliberal position insists that America's economic dynamism is due in large part to free-market reforms, that Anglo-American institutions embody a distinctive global standard, and that Japan must use it as a model. The goal here is to retract the state's regulatory and fiscal levers and leave markets more scope in which to operate and determine the allocation of the income and profits that constitute its rewards. The most visible champion of this line of reformism is Takenaka Heizo, the Minister of State for Economic, Fiscal and Financial Policy. His policy prescriptions and those of other 'market fundamentalists' are a regular focus of Kaneko's criticisms.

The second major position identified by Kaneko puts its faith in the institutional status quo, propped up by the increasingly ineffective Keynesianism of massive public works programmes. Though there has been some reduction over the past three years, Japan's expenditures on public works are still roughly 5% of GDP -- well over twice the level found in other advanced industrial societies. Kaneko condemns LDP pork barrel spending, and polls show that most voters agree in principle that the approach has been tried and found wanting. But there is more reluctance when it comes to specifics. This immobilism reflects a political economy that emphasizes stability and equity within groups and is able to pass the debts from dithering on to future generations (2000: 184-91).

Kaneko argues that Japan's reform debate is stuck between these two polarized positions and that both of them risk driving the country's economy and society into chaos. Market fundamentalism, with its emphasis on the bracing shock of competition and minimalist safety nets (in order to avoid moral hazards), would simply depress consumption and exacerbate deflation. Kaneko points out that these consequences ensued from the Reagan and Thatcher reforms in the UK and US, and would be devastating in Japan's present state. In this connection, it bears noting that in October 2002, Takenaka's talk of market-fundamentalist reforms to the banking sector and bad debts led to a spectacular flight of capital from the stock market. Dubbed the 'Takenaka shock,' it sent the Nikkei stock index into a dangerous downward spiral that was only stopped by public backtracking and assurances that the minister had been severely upbraided by LDP heavyweights on behalf of the banks.

However, continuing with the status quo poses grave long-term risks as well. The gargantuan public debt built up under the current political order has not brought the high interest rates that would have resulted if domestic savings were as scarce as in, say, the United States. But as Kaneko and a host of other public finance specialists have warned, the risk of Japan's falling into a 'debt trap' increases with each weighty dollop of deficit spending. A debt trap refers to the grave situation that occurs when a country is forced to issue new bonds in order to finance interest payments on past debt. Borrowing money to pay for past borrowing, especially when much of it was spent on unproductive assets, means deep trouble. As the state prints more and more of its increasingly dubious currency, the result is often hyperinflation and the politically destabilizing impoverishment of the middle classes (Jinno and Kaneko 2000: 37-9).

## 2. The Unsustainable Global System

Japanese politics sorely lacks strong leadership with a consistent and credible vision of where to go. It also confronts an increasingly unstable international context. The current regime of Prime Minister Koizumi Junichiro roared into office three years ago on a powerful wave of popular support for his promises of thorough, indeed "painful," 'structural reform.' But Kaneko argues that the Koizumi regime, which has since sunk deeply in the polls, squandered a golden opportunity by not going far enough in its reformism.

In Kaneko's view, the Koizumi government does not truly grasp the gravity of the challenges confronting Japan. Its economic policymaking failed dramatically in 2002 and again in 2003. These failures stem from the Koizumi regime's faith in the optimists' consensus that America would rebound from the short and shallow 2001 recession with a V-shaped recovery and pull in Japanese imports (2002: 146). The American recovery was to provide the critical extra demand that Japanese consumers and capital spending could not supply and that the Koizumi regime insisted the state should not provide. And there has been what many analysts are desperate to declare a recovery in Japan, with a recent upturn in growth, incomes and employment. But it is dependent on the long-promised and always imminent Bush recovery as well as the now fading burst of demand from China. Koizumi thus appears to be lost when it comes to economic strategy. Indeed, rather than go for the heart of the Japanese economy's problems, through fixing the NPLs and public finances, like some unhorsed Quixote he desperately pursues his obsessions of privatizing the highways and post office.

Kaneko provides a gloomy account of the context that the Koizumi regime is either ignoring or simply cannot understand. His assessment of the global economy draws partially on Schumpeter, Kondratieff and others' studies of economic cycles. These ideas generally get a renewed hearing during economic crises. But Kaneko revises the original insights of wave theory in light of the globalization of financial markets and the emergence and implosion of asset bubbles in Japan and the United States.

Thus Japan confronts long-term stagnation in the increasingly forbidding context of industrial transformation and its attendant crises. Employing a historical perspective, Kaneko finds many similarities between the current Koizumi regime's efforts and the disastrous deflationary policies of the pre-war cabinet of Hamaguchi Osachi, prime minister in 1929-30 and again in 1931 (2002: 57-9). But he also emphasizes that the present differs from the 1930s, notably in the public sector's capacity to respond to and prevent crashes by pumping liquidity into the financial markets. However, this monetary relaxation presents a new set of problems, particularly a tendency towards the eruption of 'mini-bubbles' throughout the global economy. For example, the near future may see the collapse of what many analysts regard as bubbles in the British and American property markets.

The proof of the pudding is, of course, in the eating. Kaneko's strong doubts about a sustainable recovery in the American economy, expressed in the summer of 2002, look quite prescient from the vantage of April 2004. Certainly a quick glance at America's over 4% rate of economic growth satisfies most analysts. But look at the US and global economies more closely, and one sees an awesome set of bubbles ready to burst.

In his 2002 book, Kaneko warned of the potential for new bubbles in the US economy in the wake of the speculative boom and bust of the late 1990s. That has clearly occurred. With the American establishment unwilling to reform the system's reliance on speculative excesses, Federal Reserve Board Chairman Alan Greenspan has fuelled continued consumer spending -- the engine of the American economy -- with an enormous bubble in the property markets. As Benjamin Wallace-Wells tells us in the April 2004 edition of *Washington Monthly* (<http://www.washingtonmonthly.com/features/2004/0404.wallace-wells.html>), "American homeowners have gained \$1.6 trillion from refinancing" their mortgages over the past five years, and they have spent almost all the money on consumer goods. But there has been a spectacular increase in property prices, particularly in 20 urban areas in 8 states. The value of housing in these areas is fully half of America's

contemporary housing wealth, and prices are many multiples of the family incomes of the homes' occupants.

In addition, Kaneko points out that not just Japan, but the entire global economy became highly dependent on American growth and demand during the 1990s. The sustainability of this US-centric regime and America's unprecedented trade deficits has reached its limits. However, rather than ending in a full-blown crisis, Kaneko expects the system to slide into a protracted deflationary recession. In an elegant turn of phrase, he refers to this process as a 'slow panic' (2002: 97). The challenge for Japan, then, is to use the power of the state and the public finances wisely in order to fix itself and deal with shocks from the current international system's decline and transformation.

Like many observers, Kaneko believes that the disposition of Japan's bad loan problem requires the use of public funds (to rebuild the banks' reserves) and the rescheduling of debt for firms in the grey zone. But in tandem, there must be strict inspection standards as well as a thorough investigation of bankers' responsibility for the financial debacles of the 1990s. Kaneko warns that fixing the bad loan problem will only serve to prevent a collapse of the financial system: it will not restart Japan's economy and could lead to a serious crisis of its own making if not coupled with stimulative measures.

Some observers, wanting the state to back off as much as possible, appear confident that tax cuts would provide sufficient stimulus. But Kaneko argues that the emphasis should be on spending. Yet rather than expand the deficit and pump more large-scale public works into the economy, what is required is a full-scale reconstruction of the flow of public finances and a concomitant shift to small-scale projects and welfare-related services (especially directed towards the needs of the environment, the aged and the handicapped). In particular, because over two-thirds of Japanese public spending is done at the local level, fiscal decentralization features prominently in Kaneko's reform model.

Kaneko doubts that the Koizumi regime understands how serious the risk of a hard landing is and how grave its consequences could be. There are, for example, 6.3 million workers in the construction industry, and about 40% of them are over 50 years old. Given the intensity of the current crisis and the additional threat posed by mass unemployment among such workers, Kaneko advocates -- as an immediate, emergency measure -- transforming most of the 13 trillion yen per annum paid out by central government in specific subsidies into block grants, with a later full-scale decentralization of fiscal resources (1999: 187-189). This would help break up the centrally dominated networks of political influence that prey upon Japan's public works and restrict policymaking flexibility in other areas of administrative activity.

To avoid simply increasing the local politicians' opportunities to spend on pork barrel programmes and projects, the reform would also have to be accompanied by opening up the local bidding and accounting systems. Kaneko therefore argues that the emergency measures must include expanded access to information, 3rd-party oversight and participation by local residents in key areas of decision-making. He also recommends the permanent transfer of officials from central to local governments to help beef up local administrative capacity. Many of these measures have been mulled over for years as Japanese policymakers dawdled towards fiscal and administrative decentralization. With the notable exception of MOF, most interests agree in principle that shifting fiscal resources -- including the bulk of the income tax -- and decision-making to the local level is necessary in order to erode pork-barrel incentives and respond more effectively to diversifying local needs. Kaneko's approach, which he describes as a 10-year soft-landing, offers an innovative way to simultaneously cope with the current crisis while making major advances towards these long-term goals.

### 3. Wanted: More Japanese Public Intellectuals

Being both popular and prolific is of course often the kiss of death for one's reputation in the academic community, especially for scholars who do not plant themselves firmly in one or another ideological camp. Japanese economists are strongly divided between neoliberals and Marxists, and Kaneko's 3rd way critique is generally not appreciated by either camp. Moreover, his work has until recently been ignored by the conservative business press, especially the *Nihon Keizai Shinbun*.

On the other hand, as Paul Krugman has shown in his own popular work, including his column in the *New York Times*, academics can do their communities a real service through the role of public intellectual. Back in the late 1980s, Russell Jacoby (1987) lamented the decline of American public debate due to the specialization and abstruse discourse encouraged by universities. But there is a lively public-policy debate in America's op-ed pages and the quality press such as the *New Republic*, the *New Yorker*, and many others. Japan has to some extent its own counterparts in the monthly journals *Sekai*, *Chuo Koron* and the like, yet there is no denying Japan's relative scarcity of forums that encourage critical thinking, such as think tanks and other independent centres of opinion. Japan has nothing to match, for example, *Citizens for Tax Justice*, the *American Enterprise Institute*, and other such organizations engaged in independent economic analysis. The comparative lassitude of Japan's public debate makes Kaneko's work especially valuable because of his willingness to engage a broad spectrum of viewpoints. His co-authors include Mitarai Fujio, the Vice-Chair of Japan's flagship business federation, *Nippon Keidanren*, as well as KPMG Japan President Kimura Takeshi, who in late 2002 was appointed to Takenaka's financial emergency task force. In drawing on their experiences and ideas and adding them to his own, he is truly constructing a 'made in Japan' vision of economic reform.

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