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Any serious observer of the Japanese economy follows the work of Richard Katz. In two closely argued, well-documented books, *Japan: The System that Soured* (M.E. Sharpe, 1998) and *Japanese Phoenix: The Long Road to Economic Revival* (M.E. Sharpe, 2003), Katz set out the view for which he is best known: that Japan once had an economic system that worked brilliantly but no longer does. Katz continues to elaborate this thesis in his writing for *The Oriental Economist* where he serves as Senior Editor. Katz argues that Japan's failure to overhaul its political economy has led to the emergence of “two Japans” -- a hyper-efficient export sector and an inefficient, backwards set of companies that primarily serve Japan's domestic market. He maintains that it was these companies, protected by rigid, obsolete political arrangements, that pulled the entire country down into a trough of stagnation and keep it from fulfilling its potential.

Katz's “system that soured” take on events forms an immediately attractive alternative to the once-dominant paradigms of thinking on Japan: the increasingly threadbare *reculer pour mieux sauter* school that persists in seeing Japan’s recent difficulties as grossly exaggerated bumps on what remains a well-planned road to global economic dominance; Eamonn Fingleton is perhaps the leading representative of this view. And, on the other side, the “rational choice” ideology of observers such as J. Mark Ramseyer who dismiss as a “myth” any notion that there was ever anything distinctive about Japan's economic methods. Katz's take on things, by contrast, seems like common sense, allowing one simultaneously to acknowledge that at one time, Japan really did pull off something remarkable, but that things in the past two decades have not gone well. And that the poor performance of recent years can be traced directly to a failure to overhaul the political framework that once fostered something close to an economic miracle but that now acts to block reform.

Katz’s recent prominence is due, however, not simply to this common sense and his many virtues as a writer
and an economist. After the Japanese bubble ended in the early 1990s, discussion of the country almost disappeared into the shadows cast by China's rise and the resurgence of the American economy. But with the bursting of the US housing bubble and the implosion of American finance, Japan has again become an object of attention. Not so much because of what Japan is or is not doing today (although the scary numbers coming out of Tokyo are, to be sure, being noted worldwide) but because of the eerie similarities between what seems to have happened in Japan 19 years ago and what is going on now in the United States.

Katz has weighed in with his thoughts on the supposed parallels in the March/April issue of the mouthpiece of the American policy establishment: *Foreign Affairs*. The subject matter, timing and venue all assure a wide hearing. And Katz lays his cards right on the table with the title: “The Japan Fallacy: Today’s U.S. Financial Crisis is Not Like Tokyo's 'Lost Decade.'”

Anyone who knows Katz’ writing thus looks forward to a vigorous dispensing of all the hoary untruths that have somehow become conventional wisdom: that the Japanese economy collapsed in the 1990s (it didn’t); that one can accept at face value the Western labels pasted on economic institutions in Japan such as banks, bond markets, and corporate financial reporting (one can’t). Above all, one expects a debunking of the widespread notion that American policy makers should use the actions of their Japanese counterparts back in the early 1990s as a sort of perfect inverted guide – doing what they didn’t do (i.e, moving fast to cut interest rates instead of “dithering”) and not doing what they did do (i.e, protecting “zombie” companies and banks that should have been allowed to die) – that somehow by “learning” from Japan’s “mistakes” the US can avoid that country’s “lost decade.”

Katz starts off on the proverbial right foot by forthrightly labelling comparisons between Japan’s experience and what the US is going through as “wrong”. But when he moves on to write that the “scope” of the US crisis is “far smaller” and that the response of policymakers has been “quicker and more effective”, one begins to wonder. To be sure, last year the Federal Reserve cut interest rates much more quickly than the Bank of Japan did back in the early 1990s. The Obama administration clearly understands the need for sustained fiscal stimulus to pull the United States out of the downward spiral; its nominal counterparts in the dizzying succession of cabinets that followed the fall of the Takeshita government in 1989 gave every impression that they were not even convinced Japan was truly in trouble. And as Katz notes, this was not simply a matter of foot-dragging on fiscal stimulus but also “a failure to address the loan crisis.”

But while the White House may be making all the right noises about fixing American finance, a growing number of astute observers (see the *Newsweek* article as well as the Simon Johnson
piece in The Atlantic) worry that the administration has fallen into the grip of what Willem Buiter of the London School of Economics calls “financial capture.” Buiter writes that he had initially feared that people such as Lawrence Summers, Director of the National Economic Council, and Treasury Secretary Timothy Geithner (not to mention President Obama himself) had become victims of “cognitive capture.” That is to say, well-meaning as they might be, they had spent so many years in and around Wall Street that they were unable any longer to conceive of how an economy not run by and for finance capital could possibly function. But watching the dissembling out of Washington and London, Buiter fears “it is becoming increasingly hard to deny the possibility that the extraordinary reluctance of our governments to force the unsecured creditors (and any remaining non-government shareholders) of the zombie banks to absorb the losses made by these banks, may be due to rather more primal forms of state capture.”

If this is true – if key figures in the Obama White House are essentially acting as shills for Goldman Sachs or, to put it more politely, if they are unable to distinguish the interests of Goldman Sachs from those of the Obama administration and the American public – then the differences between Japan’s policy response to the challenges of the early 1990s and what we are seeing today out of Washington become more a matter of atmospherics than substance. (Full disclosure: I worked for Goldman Sachs between 1989 and 1991 and was asked to resign.) To be sure, since the full dimensions of the current crisis first became obvious in the spring of 2008, the American government has been a veritable beehive of activity in its attempts to contain the damage. But if Wall Street has a veto over potentially the most effective measures – nationalization; regulation with teeth – then any real difference between all the buzzing out of Washington and the distracted, ineffectual responses in Japan to the first signs of that country’s crisis back in 1990 may not amount to very much. Katz is correct, of course, that the Japanese government failed to “address the loan crisis” in any meaningful manner for some years. But if any real lessons are to be learned from their response (or lack thereof) to that earlier crisis, it is crucial to understand why Japan’s policy officials refused to do what received opinion at the time told them they ought to – and it is not a matter of stupidity or obstinace.

Since 1927, Japan’s financial institutions – most particularly the great “city” banks and the long-term banks – had been wards of the Ministry of Finance (“MOF”). That is to say, their actions and their well-being were seen by the MOF (and by everyone else in Japan) as the MOF’s responsibility. MOF bureaucrats were not regulators with explicit powers delegated by law; within its recognized area of responsbility, the MOF was effectively sovereign. The political framework and mental universe in which MOF bureaucrats lived made it
essentially impossible for them to respond to the onset of the wider crisis in the early 1990s in any fashion other than the one in which they did: to do whatever they saw as necessary to keep their wards alive and functioning. Arguments that the banks needed to be broken up quickly with bad assets separated from good, with the former written down and the latter repackaged and reconstituted simply made no impact. To be sure, this did finally happen after a fashion, but not until it had become evident to everyone including the MOF itself that the MOF had lost at least some control over events; that it simply lacked what it took to maintain the shape and integrity of Japanese finance. While one can argue (and many have) that Japan could have gotten “back on track” more quickly if the MOF had acted in the early 1990s like, say, the Swedes, to be anything other than idle conjecture – i.e. to imagine that something like the Swedish solution was a serious alternative in the Japan of the early 1990s - one must presuppose that Japan’s history, political culture and power relations are something other than what they are. And it should be noted that whatever their failings, MOF officials did pull off something unprecedented in global financial history: steering their country out of what to that point was the largest banking crisis ever without a system-wide panic or a major recession in the real economy. (Between 1990 and 2002, Japan suffered anemic growth and several quarters where growth essentially stopped, but that was the worst it got.) It is by no means clear at this point that a decade or two from now, Washington will be able to look back on today’s events and make a similar boast.

The people in Washington who collectively exercise powers roughly comparable to those of the MOF and its offshoot, the Financial Services Agency (“FSA”), include senior officials of the Federal Reserve, the US Treasury, the Comptroller of the Currency, and the SEC as well as the chairs of the House Financial Services and Senate Banking Committees and their top staffers. In theory, there is nothing that prevents them from applying the same “Swedish” solution today that so many were urging back in the early 1990s on Japan: temporarily nationalize the banks, break them up, fire their managers, bring in new ones, and re-impose regulation that would consign financial institutions to their properly modest place in a healthy economy as handmaids of genuinely productive activity and stewards of savings. But as noted above, growing evidence suggests that men such as Summers and Geithner are realistically no more capable of doing so than were their MOF counterparts back in 1990. Their personal fortunes - not just the money in their bank accounts but their prospects for future earnings and stature, their webs of personal associations, and above all the mental constructs that govern what they see as possible, prudent, realistic - no longer permit them to distinguish the well being of Goldman Sachs from that of the country that they theoretically serve.

Here is the kind of lesson that the
Japanese experience really might offer if analysts could lift their heads for a moment out of their charts and numbers and consider what it is that determines the actions of policy makers in a crisis and how power reacts when it finds itself suddenly threatened by the consequences of its own decisions and arrangements. There are certain things that we can be sure that a Saito Jiro (the MOF administrative vice minister in 1993 when Japan’s crisis started to turn really ugly) or a Henry Paulson will not do. They will not stick it to their friends, former superiors and colleagues – the people whose opinions they hear all the time and whose respect matters to them – whether those are ex-MOF officials scattered throughout the upper echelons of Japanese finance and politics, or Goldman Sachs alumni managing hedge funds, heading up banking behemoths, and visible everywhere in the corridors of power in Washington and New York.

Of course there are crucial differences as well between the American and Japanese situations – differences that can be equally illuminating. MOF officials lived in a hierarchical universe where they sat on top; the banks were their dependents, their wards. It may be an exaggeration to say that things are neatly reversed in the US – the US Treasury does not yet function solely at the beck and call of Goldman Sachs -- but it is significant that the closest parallel in the United States to the career arc of a successful MOF bureaucrat –graduation from the Law Faculty of the University of Tokyo, 25 years at the MOF, and then a senior position in Japanese politics or banking – is that of the typical investment banker at Goldman Sachs with his Ivy League college and Harvard B-School degrees, two decades or so at Goldman, and then a slot in the upper reaches of American government or finance. Certainly the power and perks of the two are comparable, although, to be sure, their earnings diverge widely. The monetary rewards that accrue to MOF bureaucrats, even in their post-MOF years, are sufficiently modest that these men can do without the contorted mental gymnastics of their Americans counterparts required to square personal holdings with notions of selfless devotion to the public good.

An even more significant difference: there is no practical means in the Japanese system by which outside institutions –whether legislative, judicial, or more broadly political – can impose any kind of formal oversight or accountability on the MOF. It is true that the MOF’s failure to maintain control of events in the 1990s led to something of an open season on the Ministry, up to and including the devolution of some of its powers to the new FSA. But the MOF is still, essentially, unaccountable and at least some analysts argue that the forming of the FSA – staffed as it is largely by MOF “graduates” -- actually increased the MOF’s reach in the Japanese power structure.

There is no such ambiguity at least with respect to the US Treasury, not to mention members of the White House staff. Geithner and Summers serve at
President Obama’s pleasure; both Obama’s two immediate predecessors replaced Treasury secretaries with whom they were unhappy. By contrast, a Japanese prime minister or finance minister can neither remove nor appoint a MOF administrative vice minister (jimu jikan). (To be sure, the institutional grounding of the Federal Reserve more closely resembles the Japanese set-up; although theoretically Congress can instruct the Fed to do as it says, in practice the Fed’s lack of accountability and freedom from oversight resemble that of the MOF.) This raises the troubling possibility that despite Obama’s manifest skills as a politician and his seeming commitment to the wider good, that he too is unable to resist the cognitive and financial capture of Washington by Wall Street – or, what is worse, does not even see it. The absence in the administration of any economist of major stature -- Joseph Stiglitz, Paul Krugman, James K. Galbraith – who has criticized Wall Street’s overweening influence in today’s Washington helps, alas, to support this conclusion. Katz writes that “the ideological excess and power of financial-industry lobbyists” led directly to “the sub prime mortgage fiasco of 2007-8” and he is surely right about that. But Katz is a little too quick to praise the current administration for its “speed and efficiency” in tackling at least the financial crisis; indeed when one considers the opaque clouds of verbiage that cloak the various bank-rescue schemes announced by Geithner, one is reluctantly led to the conclusion Richard Madsen reaches in his response to Katz’s article to be published in the upcoming edition of Foreign Affairs, “The ad hoc policymaking and official vacillation displayed by the Bush and Obama administrations resemble nothing so much as the behavior of Japan’s leaders in the early 1990s.”

Even more troubling than Katz’s attempt to give the Obama White House a free pass on its reluctance to bridle Wall Street is his contention that America’s problems are a result of fixable policy errors rather than “intractable structural problems” while Japan’s “malaise was woven into the very fabric of its political economy.” Few knowledgeable observers would dispute Katz’s latter point, or his fingerling of the ultimate root of Japan’s troubles in the country’s “economic anorexia” -- the secular downtrend in real household income as a percentage of GNP that he discusses -- and the resultant shortfall in demand. “To pump up business investment,” as Katz puts it, the authorities were essentially forced to blow bubbles. And Katz, who chooses his words with care, is absolutely right to suggest the 1990s was a crisis of Japan’s “political economy” (emphasis added) with the implication that any permanent escape from that country’s predicament lies beyond narrow, technocratic policymaking.

But when Katz turns his attention to the United States, suddenly the worst economic downturn since the 1930s is “the result of discrete correctable mistakes” that can be fixed by “aggressive reform of (American) financial architecture and CEO
compensation system” rather than the “thorough overhaul of its political and economic institutions and practices” that Japan must face. Perhaps so. But only if one does not see as “intractable structural problems” the evisceration of the American manufacturing base, the collapse of stable middle-class employment, the 50 million plus people without health insurance, not to mention the financial capture by private interests of the machinery of government – what James K. Galbraith calls “the predator state” in his book of that title.

We are dealing here with the criteria by which economic success is measured. Japan’s power holders have so often infuriated received opinion outside Japan because it has long been obvious that while they gave lip service to the conventional criteria – corporate profits; GDP growth – what really mattered to them was something else entirely. That “something else” is the maintenance of the discretionary power of Japan’s bureaucratic elites free of outside interference or the threat of domestic disorder. The overwhelming priority given in the Japanese system to the preservation of bureaucratic order – that of the large established corporations and banks as well as the ministries -- has, by necessity, dictated the distortion and suppression of market forces; Japan has certainly paid a price for that in terms of the conventional criteria. Even measured by one of their own key criteria – dominance of important upstream technologies – Japan’s bureaucratic elites risk failure because of their myopia and obsession with maintaining their prerogatives. Andrew de Wit has noted that Japan is already falling behind Europe and the United States in the new “green” technologies and he lays the blame directly on the iron triangle of the monopolistic major utilities, the Ministry of Economy, Trade and Industry, and the Keidanren (Federation of Economic Organizations), the premiere association of Japan’s established corporations. Together, they have blocked any serious move towards investment in sustainable energy technologies. One could also point to Japan’s relative failure earlier to capitalize on the IT revolution spawned by the personal computer and the internet as another example of how Japan has lost its touch in exploiting the commercial possibilities of emerging technologies.

American officials, by contrast, give every appearance of genuinely caring about the conventional criteria. And it is possible that the stimulus package and modest financial reforms proposed by the Obama administration will do the trick within a year or so of returning the US to a successful growth path as measured by those criteria. But even if this occurs – and many are not optimistic – it will do little to solve the “intractable structural problems” noted above. For while Japan’s power holders may treat the conventional criteria as PR for outsiders, their American counterparts on Wall Street, in the executives suites of major corporations, in Washington’s permanent establishment of lobbyists, contractors and influence peddlers find the
conventional criteria useful because it tells them whether the economy is generating sufficient cash for them to maintain the opulent lifestyles to which they have come to feel entitled. That GDP numbers and corporate profits say little about the economic insecurity that gnaws at the great majority of Americans or the ongoing and irreversible destruction of the earth’s natural capital on which our civilization depends does not seem to matter to them as long as they’ve got theirs. The US economy is quite obviously run by and for the interests of a relatively small upper and upper-middle class and, as long as this is the case, its beneficiaries will measure its “success” by Wall Street’s ability to award seven figure bonuses and the extent of corporate cost-cutting, without much attention to just how and on whose backs those costs are being cut.

Finally, even as subtle and knowledgeable an analyst as Katz persists in treating the US and Japan’s economies as separate phenomena; two unrelated stories – over here, a country with “fundamental flaws” -- a deficient political economy that “limited productivity and potential growth”; over there, a country with “sound fundamentals” that was led on a destructive joyride of “discrete, correctible mistakes” by zealots and “powerful financial lobbyists” but can now be “fixed” by the new team in Washington implementing “better policies.” But these are not separate stories at all. The “very fabric of (Japan’s) political economy” that Katz decries is a direct legacy of the emasculation of Japan’s political culture that occurred during the Occupation and by Japan’s continued status as the “client state” of the US depicted by Gavan McCormack in his book of that title. Japan’s “economic anorexia” is simply the inevitable result of the trajectory on which the country was placed in the 1950s – the hoarding of dollars and the diversion of scarce resources into internationally competitive export industries (see the discussion in Asia and the Meltdown of American Finance. Japan’s economic methods are what permitted the United States to run for two generations now a consumption-driven economy in which the steady loss of production capacity could be ignored and deficits didn’t matter. And particularly once the rest of Asia began emulating Japan– channeling funds into export industries and hoarding dollars (i.e., putting them into the US banking system) –a wall of money flooded back into the US that inevitably found its way into the run-up in asset prices that have now crashed so disastrously. True, more sober regulatory oversight might have prevented the worst of the financial shenanigans, but there is far more going on here than fixable policy mistakes. To paraphrase what was written above about Japan, to imagine that Wall Street would not, finally, do with the floods of cash that were pouring into the United States what it did, one must presuppose that America’s history, political culture and power relations are something other than what they are.
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