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Title: **Structural Gaiatsu: International Finance and Political Change in Japan**

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Abstract:

Argues that the principal contributor to changes in Japan's political economy is the decline of Japanese governmental control over capital flows and foreign exchange rates brought about by structural "gaiatsu", or direct foreign pressure. Differs from previous analysis of gaiatsu by arguing that international capital and market forces generate gaiatsu, not foreign governments, and that its influence has been worldwide as well as deeper and more ongoing than bilateral negotiating sessions and joint communiqués related to trade. Discusses how the change has catalyzed a major increase in foreign direct investment by Japanese-owned corporations, a reduction in government's ability to control corporate behavior, a diminution of intra-corporate linkages, conflict within national economic policies and the increased penetration of the Japanese economy by foreign financial institutions. Describes how the change has resulted in an emerging socio-economic gap in Japan between individuals, groups and organizations. Demonstrates how the Japanese experience suggests the transformative power of global capital markets on national political economies, particularly those that have been interventionist in nature.

Keywords: finance; policy; international trade; gaiatsu; Japan

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**STRUCTURAL GAIATSU:  
INTERNATIONAL FINANCE AND POLITICAL CHANGE IN JAPAN**

by T.J. Pempel

**ABSTRACT**

Japan's political economy has been undergoing sweeping changes in its policies, institutions, and socio-economic coalitional arrangements. While the causes of these changes are many, this paper argues that a principal contributor has been the decline of Japanese governmental control over capital movements into and out of Japan. Global capital movements have catalyzed a major increase in overseas foreign direct investment by Japanese-owned corporations, a reduction in government ability to control corporate behavior, a diminution of intra-corporate linkages, conflict within national economic policies, and the increased penetration of the commanding heights of the Japanese economy by foreign financial institutions. As a result, a socio-economic gap is emerging in Japan between individuals, groups and organizations which believe they can compete effectively in a more globalized world and those who fear they can not. The Japanese case raises and helps to resolve broader questions about the ability of national political systems to cope with financial globalization.

Today's Japanese regime differs conspicuously from what it was a decade or more ago. With the Liberal Democratic Party (LDP) again controlling the government after only two years out of office this point may not be self-evident. Yet, past institutional and policy pillars have been substantially transformed.

The bursting of the asset bubble, the collapse of land and stock prices (Noguchi, 1992: 25), the stagnation of productivity levels in manufacturing and the consequent slow growth and financial crises of the 1990s provide the most visible contrasts with the previous forty years of record-setting economic growth. But Japan's economic shifts involve reconfigurations of policy instruments and economic institutions as well.

Public economic policies have lost their past singularity, clarity or integration and now provide an ongoing zigzag aimed at competing and often conflictual goals. Major institutional changes at both the private and public level have occurred as well. Keiretsu allegiances erode as cross-holdings of stock, sub-contract relationships and main bank borrowing all decline; foreign-owned companies have gained control over many key Japanese financial and manufacturing firms; numerous Japanese-owned companies have become far more multinational and they now cumulatively export more from plants throughout the rest of the world than they do from Japan's four main islands.

Similarly in politics, the country has a new electoral system and a reconfigured and highly fluid party system. There has also

been a linear and massive dealignment of voters; a substantial reduction in the prestige and policy tools available to bureaucrats (particularly within the once invincible Ministry of Finance); as well as an enhanced policymaking role for electorally fearful politicians pushing through newer and ever more costly patronage projects. Equally importantly, the long-ruling LDP has itself become a substantially different party from its earlier namesake.

Underlying all of these changes have been a host of socio-economic transformations involving the deradicalization and marginalization of organized labor, the diminution of economic and policy influence by the organized farm lobby, and the internal fragmentation of the business sector. Massive demographic shifts have been reflected in greater urbanization, a rapidly aging population, later marriages and fewer children.

In short, a bevy of socioeconomic, institutional, and policy pillars of Japan's old regime have been irreversibly altered and a newly configured regime is fitfully emerging in its place. No single cause can fully explain the complex changes taking place in all of these arenas. But this paper argues that recent political and economic changes in Japan have been closely linked and that both have been profoundly influenced by one single factor, namely the loss of Japanese governmental control over capital flows and foreign exchange rates.

A great deal of attention in the study of Japanese politics

and economics has been devoted to the phenomenon of "gaiatsu," namely outside or foreign pressure, a focus broadly congruent with the longstanding examination of the interplay between domestic and international politics in political analysis more generally (e.g. Katzenstein, 1977; Gourevitch, 1984, inter alia). In the Japanese case, analysis of external pressures has typically concentrated on trade issues, most particularly on United States government demands for "voluntary export restraints," market openings, negotiated market shares or other specific trade or market related actions by Japanese officials within some specific economic sector--automobiles, tobacco, citrus fruits, telecommunications, pharmaceuticals, textiles, semiconductors and the like. Not surprisingly, such external pressures have often found welcome allies within Japan--industries, firms, and government officials among others--whose own preferences have coincided with the outside demands. Such "gaiatsu" has generated many substantial changes in the Japanese economy and politics (Kusano, 1984; Schoppa, 1997)

Nonetheless, unlike the argument being made in this paper, most previous gaiatsu analysis differs in at least three substantial ways. First, the focus to date has been on bilateral negotiations between the two governments. Second, the problems studied have been relatively chronology- and decision-specific; some cycle of relatively clear demands, time-bound negotiations, and agreed-upon changes have typically marked the gaiatsu process.

And third, despite obvious ripple effects, the primary outcomes have occurred within some single Japanese economic sector.

My argument differs on all three points. The pressures examined here are not generated by foreign governments so much as by international capital and market forces. As such their influence has not been exclusively directed at Japan; instead theirs has been worldwide, even if widely differentiated from one country to the next. Moreover, the pressures of global capital movements have been deeper, subtler, and more ongoing in nature than the time-bound clarity associated with bilateral negotiating sessions and joint communiqués related to trade. And finally, the pressures resulting from shifts in monetary and currency controls, capital flows, and corporate behaviors have had deep structural consequences that the Japanese government, by itself, has been unable to manipulate.

It would be absurd to contend that such structural gaiatsu has been single-handedly responsible for all of the previously noted changes in the Japanese political economy. Yet the impact of these forces has been pervasive, effecting fundamental restructurings throughout Japan's former political economy; as such this structural gaiatsu represents one of the single-most important dynamics currently operating in and on Japan today.

Were the interactions between external forces and internal change limited exclusively to Japan, this might be an tantalizing but largely ad hoc and country-specific problem. Yet, as I will

suggest in the concluding section, the challenge posed by international capital markets to deeply embedded Japanese structures and behaviors raises much broader questions about whether any single country can maintain a political economy based on values, norms and political choices that are principally domestic in character. Both the Japanese case and the broader comparative evidence suggests that this is becoming increasingly difficult in many instances.

To appreciate the changes wrought by international capital on the Japanese regime, it is helpful to begin with a brief summary of the key links between politics and economics that prevailed from the early 1950s into the 1980s. Most notable is the importance of powerful government control over Japan's intra-national movement of capital.

#### CLOSED CAPITAL MARKETS, ECONOMIC GROWTH AND CONSERVATIVE POLITICAL DOMINANCE

From the end of the U.S. Occupation through the 1980s, the Japanese political economy stood out for its unique combination of the highest annual growth rates plus the most unchallenged conservative electoral dominance among the advanced industrial democracies. Economics and politics were entangled in a virtuous embrace. Economic success was the critical glue holding otherwise fractious groups of conservatives together and a vital force in



undercutting political appeals from Japan's political left and the organized labor union movement.

Mercantilist policies of protectionism and domestic industrial nurturance were critical. Japanese policies thus contrasted with economic liberalism's focus on firms without nationality, unmediated price competition, easy market entry and the short-term economic well being of the individual consumer. In contrast, Japan's most immediate target was relative improvement in the productivity, world market share, and profitability of Japanese-owned firms.

Conservative political control was vital to this economic orientation. Unshakable dominance by a pro-business, pro-growth, nationalist, and protectionist government generated a pervasive climate allowing businesses to bank on massive and secured profits. The result was an "embedded mercantilism," (Pempel, 1997) under which electoral opponents of the conservative party and erstwhile critics of the economic tactics rarely challenged the broad underpinnings of mercantilist protectionism. Instead, the largest opposition party, the Japan Socialist Party (JSP), oriented its challenges around security, defense, constitutional and other ideological grounds with the result that Japanese elections were never seriously contested over issues of opening versus closing national markets. Thus, Japan's embedded mercantilism contrasted starkly with the embedded liberalism that John Ruggie has correctly argued permeated the economic strategies

of North American and European governments (Ruggie, 1982).

Political control over capital movement was essential to Japanese mercantilism. In the early years after the war, the government set up systematic barriers against corporate financing through bonds or equities. Both would be too fluid, risky, and beyond governmental control. The government opted instead to continue the prewar bank-centric system ensuring that scarce capital could be controlled and allocated in accord with governmentally determined priorities.

From the 1950s into the early 1970s, Japanese banking was among the most centralized and politically manipulable in the world, providing the government with sweeping controls over industrial development and corporate behavior. At the top of the hierarchy stood the Ministry of Finance (MOF) (Patrick, 1994). Next in the hierarchical pecking order stood the Bank of Japan, a majority of whose stock is owned by the ministry (Ackley and Ishi, 1976; Aoki and Patrick, 1994; Pauley, 1988, *inter alia*). The virtual absence of a private capital market in bonds and equities, along with the extremely limited amount of negotiable debt left the BOJ as the single spigot through which virtually the entire Japanese monetary and credit supply had to flow.

Below the Bank of Japan in size and prestige were the dozen or so city or commercial banks which actually provided the bulk of the major loans to individual non-financial corporations. Dependent on access to government-controlled funds, even these

large and nominally independent banks remained deeply sensitive to BOJ and MOF policy preferences. In turn, Japanese corporations during the 1950s-70s relied for the bulk of their capital on loans and trade credits rather than on equity or bonds. In the period 1964-68, for example, 8.6 percent of the external finance for the nonfinancial corporate sector came from stocks and bonds, while 86.6 percent came from loans and trade credits (Hamada and Horiuchi, 1987: 225). This high debt-equity ratio meant that behavior in the private economy could be shifted drastically and rapidly with slight changes in MOF-BOJ policies. A modest alteration in the discount rate which might take months to be felt in other countries had an almost instantaneous effect in Japan. The Japanese government thus had tremendous power to shape behavior among Japan's many deeply debt-ridden corporations; its control over capital was consequently a key element in its overall industrial development policies.

Japan's financial sector was highly cartelized and oligopolistic. Banks, securities firms, and the insurance sector enjoyed mutually exclusive spheres of operation. Long term and short-term banking were also insulated from one another, as were ordinary banking and trust banking. Competition among all financial institutions was strictly limited by a series of government regulations; new entrants to the system were severely limited. And the system as a whole moved in what was known as the "convoy system," i.e. the naval maneuver whereby all ships move at

the pace of the slowest ship (i.e. the least innovative and profitable institutions). Individual failures by financial institutions were prevented by a mixture of extreme caution, collaborative support within the sector, interest rate controls, relatively guaranteed profits, and heavy MOF regulation.

Also critical was the fact that virtually all of the relevant capital within the system was domestic, not international. MOF policies deliberately insulated Japanese capital markets from world capital markets. High household savings, rather than foreign loans or overseas capital investments, was the major source of this internal capital. Japanese borrowers, for all intents and purposes, were prevented from raising money through international capital markets or individual corporate equity or bond issues; instead, they were dependent on the home market, Japanese banks, and ultimately on the BOJ and the MOF.

Several major consequences flowed from this pattern of capital control. Among the most important, no Japanese firm could easily move its operations abroad, nor could foreign-owned firms easily enter Japan. In 1949-50, the government enacted two laws which remained in effect until 1980, the Foreign Exchange and Control Law (FECL) and the Foreign Investment Law (FIL). Both bolstered the barriers against external penetration and helped to prevent most direct overseas investments by Japanese companies. Among other things, the FECL imposed a strict quota system on the allocation of foreign currency for import purposes, thereby

providing continued protection to domestic industries. Furthermore, the FECL was based on the "negative principle" whereby all foreign exchange transactions were effectively prohibited; the few exceptions furthered the government's abilities to set and enforce strict priorities on foreign exchange usage. Thus, from 1951 until 1971, total Japanese direct foreign investment totaled just slightly over \$4 billion, with nearly 60 percent of that total coming in the last three years of the period (Krauss, 1972: 166-68). Through fiscal 1972, nearly three-quarters of Japan's limited overseas investments were in non-manufactured items. Japanese manufacturing firms were only minimally active as overseas investors.<sup>1</sup>

Even more importantly, strict limits were placed on potential acquisitions by foreign investors within Japan. Only a handful of foreign majority-owned subsidiaries were approved during the 1950s and early 1960s. Furthermore, extensive cross holding of shares by Japanese companies minimized the chances for hostile (primarily foreign) takeovers of any companies. Thus, while elsewhere in the world U.S. multinationals were rapidly expanding their overseas operations, Japan was a less popular host for such m.n.c. investment than any other industrialized country, as well as such less appealing markets as Columbia, Peru, and the Philippines (Encarnation, 1992: 49-50).

The system of capital controls and debt financing also contributed to the extensive web of linkages among Japanese firms.

A sizable portion of Japan's larger and more successful firms, including most of the major trading companies and commercial banks, were members of broad industrial groupings known as keiretsu. The most important link among keiretsu members was their common reliance on a common main bank, plus normally a trust company and an insurance company all of which provide varying financial services for the member firms. In addition, most keiretsu include a major trading company to buy, sell and to provide international trade credits on behalf of the member firms. Also linking the groups to one another was an elaborate system of cross holding of one another's stocks. Freed from the short-term concern with returns on capital so endemic to equity markets, such firms held up to 60-70 percent of the total shares issued on a semi-permanent basis, thereby effectively creating major links among Japanese firms while simultaneously providing a barricade against hostile takeover through stock purchases. The main keiretsu then, as now, accounted for a substantial portion of the total economic activity in Japan. Generally speaking, the top six account for roughly one-quarter of the national GNP and roughly three-quarters of the value of all shares on the Tokyo Stock Exchange (Fortune, 1991: 76).

Integrated into the keiretsu were a number of smaller firms--contractors, sub-contractors, wholesalers, distribution outlets and the like--typically linked to the larger firms through loans, technology and personnel transfers, long term contracts and the

like. This arrangement meant that many of Japan's smaller and medium sized firms, despite real disparities in power, shared a similar economic and structural destiny as Japan's more advanced and high value-added firms. Such extensive horizontal and vertical linkages mitigated in Japan the otherwise stark economic differences between sectors and firms that divided firms in other countries--small vs. large, exporter vs. importer, finance vs. manufacturing, or sector vs. sector. In addition, intra-keiretsu employee transfers was an important mechanism to reduce overall unemployment. In effect, elaborate keiretsu linkages kept a high proportion of Japan's economic actors in general agreement with one another and with the broad economic policies being pursued by the national government.

At least three other discreet elements linked to the specific character of Japanese capital control policies should be noted: a low value to the Japanese yen; low cost of borrowing for targeted firms; and finally, selective access to scarce capital.

From 1949 until the end of the Bretton-Woods System in 1971, the Ministry of Finance kept the yen closely linked to the U.S. dollar at the rate of ¥360 to \$1. As the Japanese economy grew in strength, and as Japan's balance of payments became increasingly positive, the yen became ever more undervalued. While this undervaluation undercut the purchasing power of the Japanese consumer (along with that of Japanese importers) it was a boon for Japanese exporters as their prices became increasingly attractive

internationally. Moreover, the low yen provided an additional barrier to foreign imports.

Cheap capital was a second feature of MOF's capital control policies. Because Japanese firms and Japanese citizens were essentially prohibited from investing abroad and foreign capital that entered Japan was controlled through the FECL, Japanese capital markets were effectively insulated from changing interest rates and capital markets worldwide. Meanwhile, Japanese personal savings rates, for a variety of reasons, were among the highest in the world but the savings instruments available to individual Japanese savers were strictly limited. For most individuals, the logical place to deposit their savings was in the Postal Savings System. Interest on these accounts was typically the highest legally available rate in the country and was tax-free. Yet, real interest rates were governmentally set at exceptionally low rates that provided negative real returns to Japanese savers. Ultimately this meant that vast sources of money deposited into the Postal Savings System and the Post Office Life Insurance System were available to MOF through the Fiscal Incentive and Loan Program (FILP) for subsequent lending to corporations as well as for public projects (Calder, 1990; Anderson, 1990), Ishi, 1993; Noguchi, 1995).

High personal savings and low interest rates meant that governmentally targeted sectors and individual firms could gain access to scarce capital at extremely low rates. In effect, money



could be mobilized for such sectors and firms by a chain of command that ran from the Ministry of Finance through the Bank of Japan, down through the various city banks and on to the individual banks that "pushed" low cost capital onto specific firms.

Finally, the Japanese system did not depend on a generic policy of cheap money. Doing so would have risked broad scale inflation, the dramatic reduction in scarce foreign reserves, and a dangerous overheating of the economy. To prevent scarce domestic capital from being equally available to all potential borrowers, MOF, starting in late 1957, began a policy subsequently known as "window guidance," under which individual banks, again through the linkages back to the Bank of Japan and MOF, were "encouraged" to lend to specific firms, or types of firms. Hence overall monetary policy could be kept "tight" while specific exceptions could be made for targeted industries, thereby encouraging highly selective expansion of sectors of the economy. This resulted in generally sound investments within productive high-value-added sectors, and cumulatively, in high national economic growth.

As noted above, high growth, in turn, prevented otherwise internally conflictual economic and political interests from fracturing surface level conservative cooperation. Continually expanding national resources greatly facilitated congeniality between technologically sophisticated and relatively backward industries, importers and exporters, finance and manufacturing,

urban and rural interests, and otherwise fractious bureaucrats, business leaders, and politicians. Firms could be profitable despite sometimes larger than necessary workforces; oligopolies had numerous incentives to minimize price competition and to adhere to cartel arrangements; corporations could strike less-than-maximally-profitable contracts with keiretsu partners or with subcontractors, suppliers and distributors in the interest of maintaining solid long-term relationships. Japanese farmers, small and medium-sized firms, construction, and a host of firms and sectors that had lost (or had never enjoyed) international competitiveness could be afforded economic protection. Conflicts that might have become zero sum under less expansive economic conditions were more readily reconciled through side payments, compensation, and trade-offs to particular interest groups, sectors, voting blocs or geographical regions. As Kume (1992) has suggested, any rough edges within the regime could be sanded down by surplus economic resources allowing the system to follow a "politics with no losers."

All of this was dramatically undermined by the greater internationalization of Japanese capital markets. As the government lost its ability to control the capital market the bifurcated character of Japan's underlying economy became more and more stark and new fault lines began to develop within Japan's political economy between firms, sectors, and citizens that were highly competitive in world markets and those which were not. As

that happened, a number of once highly integrative economic and political institutions began unraveling, leaving important groups free to form and enter new economic and political allegiances. The socio-economic arrangements so critical to the coherence of the old regime became splintered as policy choices separated potential winners from potential losers and the continuation of a positive sum political economy became increasingly problematic. The result was the rapid unraveling of the ancient regime.

#### CAPITAL MOVEMENTS AND STRUCTURAL CHANGE

The old regime has unraveled on various fronts but six deserve underscoring because of their direct ties to changes in capital markets. First, there has been a substantial increase in the overseas operations of Japanese-owned firms. Second, there has been a diminution in the power of Japanese government agencies to shape corporate behavior. Third, there has been erosion in the once-tight links among the Japanese keiretsu, particularly in the declining centrality of Japan's main banks and other financial institutions. Fourth, public policies have lost their previous ability to generate substantial economic growth. Fifth, Japanese financial markets have been substantially penetrated by non-Japanese corporations. And sixth, as all of these have occurred, the overall socio-economic cohesion that once characterized

Japanese conservative rule and mercantilist policies has been simultaneously shattered. New fault lines have consequently emerged between those whose economic interests are best served by greater internationalization--of capital movements, production, regulation, corporate partnering and the like--and those whose interests remain served by a preservation of the older system of protected domestic markets.

These myriad changes are linked to one another. In turn, they have triggered ripple effects in additional areas including among others rising unemployment, changes in stockholding patterns, altered patterns of public finance, rising bankruptcy rates, and a massive nationwide financial crisis. The collective effect has been a substantial undermining of the institutions, policy matrix and socio-economic alliances of the former regime.

The unraveling can be traced most fundamentally to the loss of governmental monetary and currency autonomy that began in the early 1970s. The yen, long pegged to the dollar at the rate of ¥360 began to float in value once the Bretton Woods system of fixed exchange rates broke down in 1971. Four cycles of major appreciation were followed by one of substantial depreciation. The yen rocketed from ¥360 to ¥290 between 1971-74; from ¥290 at the beginning of 1977 to ¥170 by October of 1978; to ¥110-120 as a result of the G-5 Plaza Accord of September 1985; (Lincoln, 1988: 252-65 and peaked at just below ¥80 to the dollar in 1995. Over that period the yen went through by far the industrial world's

most rapid currency appreciation (Bergsten and Noland, 1993: 15, 233). Then, reversing direction, it fell sharply over the next three years into the ¥140-145 range by summer 1998, marking the industrial world's sharpest depreciation.

Major shifts in private and government sector economic policy followed inexorably with the loss of fixed and undervalued exchange rates. At the level of the individual corporation, the appreciating yen made it economically suicidal for many Japanese firms not to invest abroad. Continuing to manufacture at home became ever more costly in yen terms while the rest of the world's land, labor, and corporate valuations were reduced to fire sale prices. Japanese firms responded with alacrity to their new economic opportunities and capital began to flow out of Japan into overseas manufacturing operations, portfolio investments, real estate, and the like (Keizai Koho Center, 1987: 56).

Even in the late 1970s, Japanese investors accounted for only 6 percent of direct investment outflows from the major industrial nations, 2 percent of equities outflows, 15 percent of bond outflows and 12 percent of short-term bank outflows. By the late 1980s, these figures had jumped from three to ten times, reaching 20 percent of international fdi, 25 percent of equities, 55 percent of bonds, and 50 percent of short-term bank loans (Frieden, 1993: 434). By 1996 cumulative Japanese investment abroad totaled nearly \$500 billion, making Japan the world's second largest overseas investor and the world's largest

creditor.<sup>2</sup>

The initial economic results of the moves abroad were deceptively positive: cheaper land and labor helped corporate profits; access to previously difficult markets was facilitated; trade frictions between Japan and many of its bilateral partners were reduced in many sectors. Beneath the surface, however, the rising value of the Japanese currency and the moves of Japanese production and capital abroad were simultaneously sowing the seeds of more profound changes at home.

Most importantly, numerous of Japan's most internationally competitive companies slipped the previous bonds of the MOF-BOJ-city bank system of control over access to capital. As early as 1971-72, under pressure from domestic corporations, the Japanese government had begun to liberalize conditions for overseas investment, culminating in the 1980 overhaul of the Foreign Exchange and Control Law. By the late 1990s, such firms were free among other things to engage in a range of once-prohibited financial transactions including raising capital in foreign markets, issuing bonds abroad, engaging in a host of hedging strategies, and entering non-yen denominated transactions even with other Japanese-owned firms. Moreover, simple profitability from high growth allowed increasing numbers of firms to fund huge portions of their activities through retained earnings, rather than through borrowing from the main banks. The increase in corporate financing options correspondingly reduced the power of

government agencies to use scarce capital as a weapon of political oversight. An extremely powerful cudgel was thus removed from the government's armory of economic weapons. No longer could government agencies utilize scarce foreign reserves as a major weapon to control the behavior of many of Japan's most important corporations. Threatening a corporation with a cut off of capital had been credible only so long as capital flowed primarily through a single tap controlled by the Bank of Japan. This decline in government oversight marked a second important erosion of the Anacin regime. Strategies by numerous Japanese corporations began to be determined primarily by internal, company-specific needs rather than external government directives or national industrial policy proscriptions.

As firms turned more readily to these new sources of capital, prior links between these corporations and the Japanese banking system were also eroded, marking still a third substantial change. During the 1960s, as noted above, Japanese firms had raised the bulk of their needed capital through borrowing, primarily from their main banks. The debt-to-equity ratio for Japanese firms in 1965 was nearly 90 percent for new inflows. By 1995, this had fallen to 69.4 (Japan Securities Research Institute, 1998: 3). Bank borrowings made up nearly 77 percent of total corporate finance in 1965-69; this had dropped to 42.5 percent in 1990-91. Bond issues that had been below 10 percent jumped to 42.5 percent during the same period (Private data supplied by Nomura Research

Institute; see also Campbell and Hamao: 1994: 331-33). Quite obviously, all of these changes reduced the dependency of manufacturing firms on the Japanese banking sector, but it also began to diminish the internal cohesion among the keiretsu as a whole.

Keiretsu linkages were also reduced through the growing ties among Japanese firms and foreign partners. As Japanese moved abroad and developed global production strategies, many entered into strategic alliances with non-Japanese-owned firms to gain access to technology, capital, markets and the like (Porter: 1991: 95-117; Burton and Saelens: 1994: 58-70). Indeed, Canon went so far as to adopt as its corporate vision for the 1990s the slogan "Symbiosis with Global Partners" (Teramoto et al. 1994: 82). The very "nationality" of many Japanese firms became obfuscated, both as regards ownership but more importantly as regards the place and nationality of the workforce. These cross-national partnerings loosened the connections among individual Japanese-owned firms, their main banks, their keiretsu brethren, their sub-contractors, and the Japanese government.

In turn, a fourth major regime shift occurred, namely, the erosion of the Japanese economy's previously single-minded orientation toward the manufacture and export of industrial goods from Japan's four main islands. Indeed, by the 1990s large numbers of Japanese-owned manufacturing firms were basing their activities less on production in, and export from, Japan and far more on



truly global production and investment strategies. The single-minded export orientation so characteristic of previous Japanese economic policies gave way to far more complicated (and often internally conflictual) policies aimed among other things at enhancing social welfare, increasing domestic demand, changing the tax structure, controlling currency values, deregulation and privatization, and controlling public expenditures, to cite only a few of the changing goals (e.g. Tachi: 1991; Shindo: 1989; Nakatani: 1996, inter alia). From 1990 to the first quarter of 1996, despite the overall world marketing success of many Japanese-owned firms such as Canon, Sony, and Toyota, actual exports from Japan itself grew by only 4 percent, the lowest rate in one 12 country OECD survey (, p. 11). Even more symbolically, by 1995, Japanese owned firms were manufacturing more overseas (¥41.2 trillion) than they exported from the home islands (¥39.6 trillion) (Far Eastern Economic Review, July 4, 1996, p. 45).

In these and other ways, many Japanese firms became increasingly international in their capital formation and their overall operations and hence far more economically and administratively independent of the Japanese government and the domestic capital market. At the same time, however, many others in traditional industries such as cement and construction, deeply enmeshed in domestic public works projects and tied to the patronage generating capabilities of Japanese politicians, were either unable or unanxious to invest abroad. Similarly, certain

subcontractors of Japan's larger manufacturers followed them in setting up overseas operations, but far more, particularly the smallest, remained in Japan, despite the fact that doing so typically meant a steady dwindling of market shares and profitability.

With major exporters increasingly producing abroad, Japan saw a substantial drop in the number of manufacturing jobs and subcontracting arrangements within the home islands. During the entire decade of the 1990s, industrial productivity stagnated, remaining roughly the same in 1997 as it had been in 1990. Some one million manufacturing jobs evaporated between 1992 and 1996 with another 1.25 million expected to disappear before the end of the decade. Wage growth ceased, while official unemployment rose to the highest levels in two decades. Official unemployment was 4.1 percent in mid-1998, well above the 2.5 percent of 1993 which in turn was double the levels of a decade earlier.<sup>3</sup> Most immediately affected by the rising unemployment were women and men at the extremes of youth and old age. However, the lifetime employment system that had long protected a segment of core male workers was also abandoned by some firms and under review by far more.

Among the most important sectors that had failed to gain greater international competitiveness during the 1970s and 1980s, and that fell further behind their foreign competitors were Japanese financial institutions. Virtually all major Japanese

banks, insurance firms and brokerages remained tethered to the protectionist domestic system where they enjoyed the continued safety of cloistered markets and fixed profits that came as a consequence of the government-organized and maintained system of regulation and cartels. The financial sector was reflective of a new economic dualism that was developing between firms, sectors, groups and individuals with demonstrated capabilities to compete effectively and profitably in world markets independently of government help on the one hand, and those which, while perhaps quite powerful and profitable within the domestic market, demonstrated little competitiveness in the broader world market.

It is within this context that the Japanese bubble (roughly 1985-90) gains perspective. At least two elements are important. First, as the yen continued to escalate in value, particularly after the Plaza Accord, the Ministry of Finance, fearing the possible negative effects on Japanese exports and worried about possible electoral retaliation against the LDP for any slowing of the economy, "ordered the Bank of Japan to open the monetary floodgates while the ministry injected massive amounts of fresh spending into the economy via fiscal packages and the expanded investment of postal savings funds" (Asher, 1996: 2) Predictably, as the prime interest rate was lowered to a postwar low of 2.5 percent, asset markets in both stocks and land jettied upwards.

Second, and equally important, was the further severing of links between major manufacturing firms and the main banks and

financial institutions noted above. Cut off from their normal sources of income (corporate borrowers) and yet flush with cheap capital, Japanese financial institutions loaned money to ever more dubious borrowers. Smaller subsidiaries, less fiscally sound firms, land speculators, real estate companies, non-bank financial intermediaries, politicians, and members of organized crime families were among those who suddenly found bank loans exceptionally easy to acquire. Stock and real estate speculations were among the main uses of the new easy money. From a 7 percent annual growth rate in the second half of the 1970s, real estate lending accelerated to an 18 percent annual pace in the first half of the 1980s and to 20 percent rate in the second half of that decade (Lincoln: 1998:5).

Simultaneously, fixed stock commissions and the absence of significant foreign brokerage alternatives made the bubble's expansion particularly valuable for the nation's brokerage houses. Things were so good, at least on paper, that virtually all major brokerages offered (illegal) guarantees against losses of principal to their favored clients. Major brokerages also traded aggressively for their own accounts in the seemingly unstoppable bull market.

The late 1980s consequently witnessed a massive expansion in the value of assets such as stocks and land. The new "value" of these expanding assets in turn was used as collateral for an ever greater spiral of borrowing and speculation. The underlying

divergences within Japan's economy were masked beneath the pervasive mood of triumphalism surrounding the country's apparently unstoppable growth and prosperity under its "new economic model." Unseen by most was the hollow airiness on which this new economic model had come to rest. As the bubble expanded, low cost borrowing to fund heavy investments in stocks and real estate seemed a surefire path to profits. And intoxicated with the visions of unstoppable profitability and giddy customers, neither the banks, the bureaucrats nor the LDP's successful politicians were anxious to cut off the supply of punch. The wave of Japanese self-congratulation however proved akin to the euphoria of Icarus soaring toward the sun--just before his waxwings melted.

When Bank of Japan Governor Mieno finally punctured the bubble with a sharp rise in the discount rate, asset prices collapsed dramatically setting off a decade of depressing economics. The stock market fell from its peak of roughly ¥40,000 on the last day of December 1989 to ¥14,000 in 1993. In mid-1998 it continued to hover in the range of ¥14,000-¥16,500. Land prices plummeted by over 60 percent; in central Tokyo's commercial district prices in 1998 stood at only 20 percent of their 1990 peaks. And as the bubble burst, the underlying collateral for the riskiest bank loans was totally erased leaving banks and financial institutions with mountains of unrecoverable debt. Brokerages, meanwhile, compensated "guaranteed" accounts for the sudden losses only until such costs became excessive and until the public

exposure of their imprudent investments and criminal behavior led to a loss of clients and the elimination of brokerage profitability.

The bad loans within the banking sector alone were subsequently revealed to total at least \$600 billion with some estimates as high as double that number. Of these about one-half were probably completely worthless. Japan's problem, in consequence, was roughly 6 times greater for the size of its economy than the amount required to deal with the U.S. savings and loan crisis.

As the economic slowdown continued and the search for culprits expanded, it soon became evident that the problem went beyond "bad economics" and included "corrupt government." MOF and BOJ officials were revealed to have had incestuous and tawdry relations with those they were allegedly regulating. Elaborate bribes to banking officials had led many to give advance notice of pending audits. Government prosecutors raided the Securities and Banking Bureaus of MOF; numerous senior officials resigned and/or were arrested under allegations of corruption; the veil of secrecy over close government-business relations was at least partially opened to public scrutiny. In the process the authority and legitimacy of the government regulators was further eroded.

Increasingly, the power of international capital markets, and the corresponding inability of many domestic institutions to cope with them, began to ripple through Japan. Japanese financial

institutions with international operations were under increasing pressure to sell stocks or other assets to meet the Bank for International Settlements requirements for an 8 percent equity minimum. Simultaneously, a bevy of Japanese institutions faced massive downgrades in their credit worthiness by international ratings agencies such as Moody's and Standard and Poor's. By June, 1995, Moody's, the international rating service, had downgraded the credit worthiness of Japanese banks to an average rating of "D" (uncertain), and international money markets were imposing a sixty basis point "Japan premium" on the cost of short-term funds for Japanese banks (Lincoln: 1998: 11). The Long Term Credit Bank, for example, which had a rock-solid AAA rating in 1990 fell to just a notch over junk bond status by mid-1998, by which time borrowing by most downgraded firms became perhaps 100-125 basis points more expensive than for more solid institutions from other countries.

Various accounting scramblings, artificial infusions of government funds into the stock market, and the lowest official discount rate in the postwar years (one that was functionally negative) combined with other efforts at bailouts by the government proved insufficient to prevent the failure of a number of major financial institutions. Several major banks went under, the most notable being Hokkaido Takushoku. Between mid-1997 and mid-1998 alone, eight securities firms, including Yamaichi--one hundred years old and one of the four largest national brokerage

houses--also went bankrupt, sought voluntary liquidation, or transferred operations to another house (Nikkei Weekly, June 8, 1998).

Capital demands on both financial and non-financial companies, combined with the growing ability of individual firms to raise money abroad as well as the declining paper value of the stocks themselves led to a substantial sell-off of once sacrosanct cross-held shares, further eroding the internal cohesion of the keiretsu and other corporate connections. In 1987, approximately 72 percent of the Tokyo Stock Exchange capitalization involved such relational crossholdings. By 1996, this had fallen to 60 percent, and it was dropping at the rate of about 4 percent per year.<sup>4</sup>

One of the most important manifestations of the end of the old regime involved the increased penetration by foreign firms of the "commanding heights" of Japanese capitalism, the fifth point noted above. Among the more prominent such arrangements were those linking Nippon Credit and Bankers Trust, the Long Term Credit Bank and Swiss Bank Corporation, Nikko Securities and Smith Barney, Merrill Lynch and Yamaiichi, GE Capital and Toho Mutual Life Insurance, Meiji Life and Dresdner Bank and Nikko Securities and Travellers. As was mentioned previously, many Japanese manufacturers had entered cross-national tie-ups starting in the 1970s and 1980s as part of their general internationalization. At least two important things were different about the post-bubble



tie-ups however. First, the early alliances were typically in manufacturing with the Japanese partner often enjoying technological and/or production advantages. Second, most of these early arrangements enhanced the combined international production and marketing abilities of partners but gave little access to the Japanese market to the non-Japanese partner. The tie-ups in finance during the late 1990s were quite different. In most instances it was the Western partner(s) who enjoyed clear product and technological advantages over the Japanese counterparts. Moreover, most of the tie-ups gave the Western firm relatively easy access to the previously restricted Japanese market.

At the same time, Western investors began gobbling up properties and property-related loans as quickly as Japanese banks could bundle them into attractive packages for sale. Not only did the Japanese financial institutions get rid of nonperforming loans, but Western investors, such as Goldman-Sachs, Morgan Stanley, GE Capital and others, were thereby able to tap quickly into the Japanese real-estate market. One estimate was that in the single twelve months to March, 1998, some 30 property-related loan packages with a face value of \$21.6 billion were bought by Western investors (Nikkei Weekly, June 1, 1998). The average price for these property-related bad loans was generally about ten cents to the dollar.

In all of these ways, the once "for Japanese only" capital markets in Japan were thrown open to non-Japanese players. And

these players, in turn, had few of the political incentives of their Japanese counterparts. Instead, they were driven primarily by the internationally set costs of capital and returns on capital.

Finally, once the lubricant of high growth was removed a variety of structural frictions within the existing system became noisily obvious. The previous socio-economic alliances of the old regime became increasingly conflictual, the sixth and final major point of change. Most prominently, a new socio-economic fault line has emerged within Japan between those who have benefited from the new international openness or are poised to do so, and those for whom such openness is akin to a death sentence.

A central question that Japan now confronts is whether these emerging lines of tension will gain explicit electoral and political articulation. Hints of such a bifurcation emerged as early as 1989 and continued through the next ten years. The LDP's loss in the Upper House elections of 1989 showed its growing vulnerability in the wake of demographic changes, a series of corruption scandals, the introduction of a national three percent consumption tax (VAT), and the frictions created by the bubble. Suddenly many individual LDP politicians concluded that party loyalty no longer provided a friction-free vehicle for personal career enhancement; the LDP label might well diminish, not enhance, voter appeal. In particular, many younger urban conservatives determined that it made little sense to plan their

political careers around a lifetime of membership in a party committed to economic policies hostile to the nation's urban dwellers and detrimental to long term economic growth. To many such conservative parliamentarians, leaving the party suddenly made it possible to present themselves as more attractive, principled, and electable alternatives. The result was a split within the LDP in 1993.

The LDP's replacement by a coalition government headed by Hosokawa Morihiro gave rise to expectations that some electoral vehicle for challenging the old system would gain immediate institutionalization. Similarly, Ozawa Ichiro's role as self-styled reformer, and his ability to forge the New Frontier Party (NFP) as a party whose members disproportionately favored deregulating Japan's economy, also elicited the possibility of such a political vehicle. But Hosokawa quickly foundered on the shoals of his own corruption scandal, and Ozawa's tyrannical personality did little to advance his message, either among parliamentarians or the general public, and other institutions proved remarkably sticky. The result is that while, as of this writing, Japanese society may be socio-economically divided along the classic lines of "internationalist" versus "protectionist," it is the latter agglomeration which has been the dominant voice among Japan's seriously contending political parties. No existing party or coalition currently offers a strong commitment to greater internationalization of the Japanese economy and the promise of

institutions and policies that will advance the interests of Japan's emerging internationalists.

**CONCLUSION: JAPAN AND OTHERS IN A  
MORE INTERNATIONALIZED WORLD ECONOMY**

No new Japanese government will easily paper over the fundamental tensions and the increasingly divergent interests of Japan's competing socio-economic groups. It will be exceptionally difficult for any government to advance policies and institutions to bridge the wide gaps now separating those who are prepared for and will benefit from an increasingly internationalized and less regulated economy, and those desirous of continuing the existing protections and regulations from which they benefit. As increasingly mobile international capital continues its assault on the once insulated Japanese capital market, those tensions become ever more pronounced.

It is improbable that any economic policy mix, such as prevailed under embedded mercantilism, could provide the broad and sweepingly benefits that would mobilize most segments of the economy behind it. Yet a continuation of past policies will also elicit political and economic opposition from within Japan and from abroad. Japanese policymakers now confront deep socio-economic divisions pressing for tough choices among incompatible alternatives.

For the moment, political parties and bureaucratic institutions only hint at offering such choices. Almost all government agencies resist any mission changes that would diminish their regulatory power; few show any inclinations toward promoting greater international capital penetration. It is primarily within the business community that the voices for clearer choices and radical policy departures have been the loudest--and even here, no single "business" voice prevails. But it is certainly most plausible to anticipate that those segments of the business community most disadvantaged by the old system, because of high rates for industrial basics such as utilities, construction, transportation and telecommunications; limited financial options; and cartels predicated on survival of the weakest will have the strongest incentives to press for change.

Any such efforts are sure to be helped by the increased penetration of Japan's commanding heights by international capital markets. Vast amounts of investment money, once constrained to earn low rates of return from Japanese savings instruments, have moved into the higher yielding instruments offered by Western-owned banking, brokerage and insurance institutions. Between 1997 and 1998 alone, foreign securities holdings by Japanese investors nearly quadrupled from ¥6.3 trillion to ¥23 trillion. Whereas such holdings constituted 0-2 percent of the total assets of trust banks, investment trusts, and life and non-life insurance firms, they now constitute between 6-16 percent of the total assets of

such institutions (J.P. Morgan-Tokyo: 1998: 12). As Western-owned institutions become more established in the Japanese marketplace, and as Japanese institutions and individual consumers become more familiar with the return differential between them and the older style Japanese savings instruments, it will be hard to prevent ever larger amounts of capital from moving beyond the administrative purview of the Japanese government and the Japanese main bank system.

Politics has been slow to follow markets in Japan, but the structural changes wrought by changes in capital markets will increasingly ripen the party system to bring forth political entrepreneurs attempting to mobilize groups and voters around their increasingly divergent interests. There is no teleological guarantee that the tensions now dividing Japan will be readily translated into competing political platforms offered by different political parties. Equally plausible, at least until the pain of inaction becomes unbearable, is a continuation of a politics of vagueness and personalism that avoids any articulation of separate and clear economic choices by the major parties. And, offered few appealing choices, voters certainly have the option of staying home as they did in the 1996 election, for example. But in such a situation, it is also unlikely that any elected government will be capable of taking the kinds of bold measures needed to regenerate the national economy.

In short, Japan is facing a choice between a residual

institutional stickiness from the old regime that blurred economic alternatives versus one that offers more clear-cut economic choices but runs the risk of becoming a country with far more sharp demarcations between winners and losers.

Finally, this paper demonstrated how the Japanese experience suggests the overwhelmingly transformative power of global capital markets on national political economies. As is rather widely known, between \$1.2 and \$2 trillion in international capital exchange crosses national borders on a typical day in 1998, a figure that has been expanding geometrically in the last decade.

Thus in 1983, five major central banks (U.S., Germany, Japan, Britain, and Switzerland) held \$139 billion in foreign-exchange reserves versus an average daily turnover of \$39 billion in the major foreign-exchange markets. In other words, their combined firepower dwarfed the marketplace by more than 3 to 1. By 1986, the two were about even in size. By 1998, the balance of power had been reversed. These five central banks had \$426 billion in reserves against \$1.8 trillion in daily trading activity. Market makers had moved to a 4:1 advantage over central banks (Greider: 1997: 245; Economist May 23, 1998: 97). One of the central questions posed by such currency movements and by the experiences of Japan is the extent to which national governmental powers elsewhere will henceforth be compromised.

Global capital power is surely greatest, and most difficult for national political actors to resist, when a nation's political

economy has long been predicated on the insulation of domestic from international capital markets. In this regard, the increasing monetary integration of Western Europe that began in the mid-1970s and consolidated in the 1980s seems to have inoculated the participating economies from the kinds of rapid and dramatic system-wide transformations that have been occurred in Japan (McNamara: 1998; Cohen: 1998). Moreover, politically powerful left-labor movements in Europe have also been buffers against rapid systemic changes (Garrett: 1998; Berger and Dore: 1997). But at the same time, as Michael Loriaux and others (1997) have shown, it has been interventionist states such as Japan that have been under the strongest pressures from increased capital mobility. Moreover, Sylvia Maxfield (1997) has demonstrated that numerous middle-income countries that once had highly nationalistic banking and capital systems have been forced to undergo major transformations as a consequence of such capital mobility. Preliminarily, this mixed picture suggests that increased capital mobility will exert its potential for radical systemic transformations primarily on countries such as Japan, which were once structured so completely toward preventing its penetration.



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## ENDNOTES

1... Despite the severe restrictions on U.S. fdi in Japan during the 1960s and into the 1970s, U.S. fdi in Japan was still ten times greater than Japanese fdi in U.S. Japanese investment in the U.S. Dennis Encarnation, Rivals Beyond Trade: America versus Japan in Global Competition (Ithaca, Cornell University Press, 1992), p. 101.

2... In 1996, Japan had 16.7 percent of its GNP or \$742 billion in net foreign assets. The Economist, Nov. 9, 1996, p. 123.

3... As is now widely noted, official Japanese statistics on unemployment provide significant underestimations in comparison to methods used for such calculations in most other industrialized countries.

4... J.P. Morgan-Tokyo, Economic and Market Research, "Capitalism Coming to Japan," p. 21. Interview with Jesper Koll, July 14, 1998. This sell-off had a peculiar character, with the most marginal firms in the keiretsu abandoning the cross-holdings, but with some of the core members actually adding to their intra-keiretsu shareholdings.