IS JAPAN CHANGING?
"PERMEABLE INSULATION" IN JAPAN'S POLITICAL ECONOMY

Précis
Excerpts from "Introduction," by Ulrike Schaede and William Grimes (eds.), Japan Changes (forthcoming)

By

Ulrike Schaede
University of California, San Diego

Prepared for
How Politics Undermine Economic Reform in Japan
June 8, 2001, Washington, DC

Japan Information Access Project

Circumstances have changed dramatically in Japan between the early 1990s, when the world hailed Japan as one of its economic superpowers, and the year 2001, as the country entered its second decade of economic stagnation. Trade liberalization and financial market integration have increased pressure for governments throughout the developed world to comply with international rules. Domestically, Japan's industries have experienced structural change and deregulation.

Japan has reacted to these challenges by revising, in very pragmatic ways, its political economy, rules, regulations, industries, and policies. Interestingly, however, most of these changes have developed in ways few would have predicted. By the late 1990s, Japan observers were largely divided into two schools of "change forecast." One group predicted that in spite of all 'change hoopla' following the bubble recession, Japan would uphold its traditional patterns and continue its attempts at protectionism. The opposite camp argued that Japan would finally have to open up and fully liberalize markets and competition in order to be able to compete in the world markets.

We submit that Japan is in fact changing significantly, but it is doing so in unforeseen ways and with surprising consequences. Some policies are unprecedented, whereas others look much like previous actions. Yet, importantly, both new and familiar policies have to be considered in the new light of a fundamentally different domestic and global situation.

The main reason why Japan is so difficult to interpret these days is that at this critical juncture the past is a less than perfect predictor of Japan's future strategies. This is because almost throughout the postwar period of prosperity Japan fundamentally reacted to shocks, external or internal, from a position of comparative strength. Throughout the 1960s and '70s, Japan's economy operated under signs of enormous upward potential. "Catch-up" was not yet fully accomplished and the international environment allowed ongoing infant industry protection and export promotion. In contrast, in the early 21st century Japan is facing adversity from a position of comparative weakness. The country is struggling to adopt new models of education and business organization that may induce more rigorous efforts at innovation. Trade quarrels with the United States and the European Union have disallowed overt government policies aimed to promote exports and block imports. The continuous process of deregulation–slow and inconsistent as it may be–has led to revisions of foreign trade laws and specific industry laws since the early 1990s, progressively undermining the state's powers at administrative guidance. While the state's guidance of business strategies was never one-directional or absolute, it is now more than ever dependent on industry's willingness to cooperate.

Overlooking this underlying shift in the strength of the Japanese state will result in a misinterpretation of Japanese policies. Even when policy measures look quite familiar to the long-time observer, their causes and consequences are often unexpectedly different, forcing us to consider Japan's policy choices in the 21st century in a new light. This edited volume submits that Japan's new policy measures and their intended (and unintended) outcomes constitute a novel paradigm best described as "permeable insulation."

"Insulation" occurs in the sense that in many areas the Japanese government and economic system continue to have at their core an attempt to shield companies from full competition and the rigor of market forces. At the same time, however, this insulation is permeable because reductions in state power vis-à-vis the private sector since the 1990s have combined with reductions in the solidarity of private institutions such as *keiretsu* and trade associations to make strategies of insulation much less rigid and uniform. Thus, "insulation" in post-developmental Japan is a much more flexible policy objective, as it can be used either to stave off change or to make its pace more manageable, depending upon the sector. Now more than ever before, firms are making their own choices about how to embrace the global economy. As a result of this "permeable insulation" approach, Japan's response to the global and domestic challenges of the 1990s is neither one of retreat and denial, nor one of full acceptance of global standards and practices. Instead, the basic thrust is one of pragmatic utilization of new rules and circumstances to continue industry policies of promotion or protection in a new, post-developmental, paradigm.

Examples and case studies of policy-issue areas affected by "permeable insulation" policies are: relocation of manufacturing into Asia (Patricia Nelson); government FDI financing to support small Japanese firms in Asia (Mireya Solis); employment of WTO rules to the advantage of Japanese competitors (Saadia Pekkanen); the "internationalization" of the Yen as a means to reduce foreign exchange risks for Japanese firms (William Grimes); industry self-regulation to substitute for deregulation (Ulrike Schaede); changes in industrial policy (Mark Elder); changing corporate governance (Christina Ahmadjian); and Japan's venture capital industry (Ulrike Schaede).

A Case Study: Why Deregulation does not lead to more Open Markets

The paradox with Japanese deregulation is obvious: If it is real and effective, how can it continue for decades? Looking at legal and regulatory changes, one finds that deregulation has indeed proceeded. I submit that this process has not, and will not, lead to open markets across all industries, because of the fundamental nature of regulation in Japan, and the reactions that "deregulation" has triggered in Japanese firms.

Regulation in Japan has long focused on "entry regulation" – licenses and permits that allow a company to operate in a specific market. Once licensed, ongoing market behavior has been largely supervised through informal means, such as regular contacts between a company and the regulating ministry, or the hiring of so-called "Old Boys"–retired bureaucrats–into private company management. In contrast with the U.S., Japan has not, historically, monitored corporate market behavior in a consistent fashion, but instead has relied on informal and situational means to supervise companies. Nor have Japanese courts developed a set of case precedents to apply legal doctrine in the event that a company's market methods were found to be in violation of existing rules.

Given this focus on entry regulation, "deregulation" in Japan refers to a stepwise and slow reformulation (and occasional abolition) of entry license requirements. Yet, the Japanese government is not at the same time developing a consistent formal system of process supervision to ensure open markets. What is more, scandals, deregulation and changes in the political environment have undermined the bureaucrats' leverage in informal regulation. The resulting regulatory void is a threat to those companies that have long enjoyed the closed nature of their markets and the protection afforded by strict entry regulation. As deregulation proceeded, companies have therefore become active in filling the regulatory void by increasing their own attempts at "self-regulation". Trade associations typically assume this task, and more and more industries structure their own industry rules.

Because of this increased self-regulation, whether or not a certain market segment will open up with deregulation depends on the choices made by the incumbent firms. There are a few markets where Japanese companies have opted for more domestic competition, such as telecommunications and automobiles. However, many industries are structuring their self-regulatory rules such that markets remain closed, regardless of official deregulation programs.

These industries can do so because Japan's antitrust system does not rigorously prosecute activities that lead to market-closing self-regulation. Whereas the Japan Fair Trade Commission has recently been quite active in disallowing price cartels and *dango*, it remains reticent and legally restricted in prosecuting so-called "unfair trade practices," such as boycotts (refusals to deal with non-members of a trade association).

Increased self-regulation means that (a) deregulation will not lead to more open markets across all industries; and (b) Japan's industries will bifurcate into two main groups: those that choose to embrace more competition by allowing new entry, and those that choose to use self-regulation for purposes of self-protecting their home markets.

US Policy Implications

The Bush Administration is intent on reworking the US trade relationship with Japan. A focus of its efforts is to engage Japan in a quieter dialogue on restructuring and deregulating the overall economy. One aspect of the "new initiative" is to conduct a series of business-government discussions on regulatory and trade issues in which both Japanese and American companies have a common interest to change. This means that the Japanese business executives involved in this initiative will most likely come from what is viewed as Japan's new economy, dynamic sectors. The Administration seems to believe that these executives will use their common ground to provide the domestic push for change (*naiatsu*). Current analysis shows that this may be an excellent tact. What to watch for, however, are unintended consequences of new policy measures and resistance to change in the old economy.

References:

Schaede, Ulrike, *Cooperative Capitalism: Self-Regulation, Trade Associations, and the Antimonopoly Law in Japan*, Oxford UP 2000.

Schaede, Ulrike and William W. Grimes (eds.), *Japan Changes: Permeable Insulation in an Era of Globalization*; forthcoming 2001.

Ulrike Schaede
IR/PS – Graduate School of International Relations and Pacific Studies
University of California, San Diego
Telephone: (858) 829 1005
E-mail: uschaede@ucsd.edu

Ulrike Schaede is an Associate Professor at the Graduate School of International Relations and Pacific Studies at the University of California at San Diego, with a specialization in Japanese and international business. She writes extensively on Japanese government-business relationships and regulation, trade associations and antitrust policy, as well as financial market reform and corporate governance in Japan. Publications include: *Cooperative Capitalism: Self-Regulation, Trade Associations, and the Antimonopoly Law in Japan* (Oxford UP 2000); "Understanding Corporate Governance in Japan" (*Industrial and Corporate Change* 1994 No. 2) and "The 'Old-Boy' Network and Government-Business Relationships in Japan" (*Journal of Japanese Studies* 1995). Professor Schaede is currently involved in research projects on "Japan Changes," an evaluation of ongoing changes in Japan's political and economic landscape, and on venture capital in Japan.