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Recognizing a Mistake, Not Blaming a Model

Imagine that you have a next-door neighbor with whom you used to work on projects and play sports (at which he would sometimes beat you). This summer, leaning over the fence, you notice that he not only is avoiding neighborhood projects and games, but does nothing but sit in a lounge chair drinking beer and grilling sausages. In a friendly manner, you lean over and say, ''Hey, keep that up and you'll get a heart attack like my grandfather did.'' Your neighbor responds, ''Oh, that just runs in your family—in my family, we process alcohol and cholesterol differently. Remember, I always outran you at the community picnic, and this is the way I've always eaten.'' You walk away shaking your head, saying, ''No, it's not. I remember when he ate health food. I just hope that he doesn't keel over while driving and hurt someone else.'' Next thing you know, there's a scream as your neighbor has sharp chest pains, and you have to drive him to the hospital. It turns out to be a warning, not an actual heart attack, but the neighbor says, ''That's it, I'm changing my lifestyle, going on a diet, running everyday.'' You wait to see if he can stick to his commitment, knowing that it will be tough, but it is ultimately up to him to pursue his own self-interest.

That neighbor is Japan, and, as argued in this book, it is misguided and ultimately self-destructive macroeconomic policies that have allowed the potential for crisis, a full-scale heart attack as it were, to grow. Up through most of the 1990s, Japanese policymakers insisted that their economy followed a different model and so was not subject to the same dangers from the cyclical swings as were the other OECD economies. The official recession of 1998, the June attack on the yen, and the July upper-

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house defeat for the LDP constitute the warning chest pains. New Prime Minister Keizo Obuchi and his cabinet have promised rapid response in the form of fiscal stimulus and financial reform, just as your hypothetical neighbor promised to exercise and cut out the fat after being scared by chest pains. The question remains open whether Japan will carry through on the necessary changes to reduce the risk of outright economic crisis.

Japan's economic performance in the late 1990s is ultimately a matter of policy choice. If the Japanese government takes the necessary steps before the risks described in chapter 4 come to pass, Japan can rapidly return to growth; if the government waits too long or chooses not to change its macroeoconomic stance, unprecedentedly severe contraction could hit Japan and then the rest of Asia. The analogy to a person putting himself or herself at risk of heart disease is appropriate—the modification required is some conscious alteration of behavior, but nothing invasive or structural. The condition of the Japanese economy is not one of a chronic or terminal illness, analogous to a cancer, which would require radical chemotherapy or surgery in the form of wholesale structural reform and a long period of pain to bring about potential recovery.[1] Even the much feared long-run economic burdens arising out of the aging of Japanese society are open to change, if faced, by increasing female workforce participation, the birthrate, immigration, or the retirement age (or some smaller amount of each in combination). In other words, even the social security gap can be closed without the sort of outright pain of short-run adjustment that many of Japan's neighbors are having to face or that Japan itself faced in the 1940s and 1950s.

There is sometimes a discomfort with talking about economic policy choices and mistakes as a source of economic outcomes. Implicit in many analyses of Japanese and other nations' economic performance is a sense of determinism. If so much is at stake and there is clear reason for a course of action, how can a mistake be made unless it is the result of political forces that the policymaker cannot control? It is important to remember, however, that we all spend a great deal of time reading, writing, and sometimes lobbying about policy precisely because the discretionary acts of economic policymakers do have implications. Also, what is politically possible is a matter of both assessment and courage on the part of the elected officials in question. There was nothing preordained about the Japanese government's general adherence to fiscal austerity (as described in chapter 2) or former Prime Minister Hashimoto's specific efforts to pass a law putting a limit on budget deficits by 2003, just as there were no absolute political pressures forcing governments in the

1. Asher and Smithers (1998) take the opposite view and compare the Japanese situation to a metastasizing cancer that requires long and painful treatment. As discussed in chapters 1 and 3, the sorts of exaggeration of the fiscal problems and sources of economic downturn in Japan required for such a view are unsupported.

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1930s to adhere to the gold standard in general, or the decision makers at the US Federal Reserve to mistakenly tighten monetary policy in 1932-33 in particular.[2]

While analogies to the Great Depression come cheap in the East Asia of the 1990s, Japan's mistaken economic policy is the main point of similarity as far as the Japanese economy is concerned. The macroeconomic policy response, or lack thereof, to a financial bubble's bursting has turned a standard downturn into a prolonged recession with a risk of outright financial crisis. The problem remains serious but soluble. The underlying strengths of the economy are being eroded slowly by the downturn, yet the downturn itself is being used as an excuse for claims that the economy is inherently weak. It is this confusion about what the economy is capable of and the potential role for macroeconomic policy, not inherent political deadlock, that is the stumbling block to recovery. This reality has a broader significance beyond the likelihood of Japanese government action—it is important to take the proper long-run lessons from the Asian crisis and Japan's role in it.

There are three primary lessons to be taken from the Japanese economic stagnation and policy's role in it. First, countercyclical policy continues to matter for modern economies, and, under certain circumstances, aggressive discretionary action is appropriate. Macroeconomic failure can occur in every economy, including Japan's, and it is not prima facie evidence of structural collapse. The second is that national economic models do not determine short-run economic performance. Partly because Japan has taken so much credit, much has been made of the Japanese model as an explanation for the outstanding economic performance of Japan and the East Asian region through much of the past three decades. Since the crisis of 1997 and Japan's 1990s stagnation, almost as much has been blamed on this model. This is misguided thinking that traps policymakers into a dangerous sense of all-or-nothing choices at best and, more frequently, into a misguided belief that year-to-year economic outcomes are largely predetermined and equally affecting of all parts of an economy. The third lesson is that the creativity of destruction is overrated. Some claim that Japan must go through recession to cleanse and reform itself for future growth, echoing the calls of the "liquidationists" of the 1930s (such as Hoover's Treasury Secretary Andrew Mellon).[3] These are, frankly, mistaken ideas. Not only are they illogical in economic terms under closer analysis, but they also

2. For historical discussions of the role of ideas and decisions in prolonging and deepening the Great Depression, see Friedman and Schwartz (1963), Eichengreen (1992), and Bernanke (1995).

3. See, among others, Nakamae (1998), Asher and Smithers (1998), Ohmae (1998), and Landers and Biers (1997) for claims that Japan must go through painful transformation and that recession can be beneficial in this context. DeLong (1998) gives a historical look at discussions of US fiscal policies in the 1930s.

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misassess the relative benefits and costs of structural reform and recession (even if one allows the uncertain political premise that countercyclical macroeconomic policy is somehow in opposition to readjustment).

Countercyclical Policy Continues to Matter

A number of factors have come together to predispose policymakers against discretionary countercyclical macroeconomic policy, monetary or, especially, fiscal.[4] Some of these are recognized realities of policymaking in the 1990s: fiscal or monetary laxity is often punished by free-flowing international capital markets; macroeconomic policy cannot consistently and predictably affect the natural rate of unemployment, the potential growth rate of the economy, or other deep structures of the economy;[5] and there are long and variable lags between when monetary policy is changed and when its effects are felt, and the fiscal-policy process has still longer decision-making and implementation lags, meaning that most business cycle swings have reversed themselves before policy initiatives would work. Some of these are based on more tenuous or even dubious beliefs: the business cycle is dead in the United States or it ceased to apply in Japan; relaxing a monetary rule or a hard budget constraint automatically leads to spiraling inflation or spending through political pressure; and recessions themselves are either the result of optimizing market behavior or the necessary antidote to previous market booms.

Mainstream economists almost universally agree that macroeconomic failures do inherently arise out of the sum of numerous individual decisions in a world of imperfect information, nonhomogeneous products, and nominal rigidities.[6] In other words, if the bulk of products in an economy (including labor) are not perfectly substitutable and measurable commodity goods sold in open, competitive, spot markets, like oil or wheat, then, even if people make the logical decisions, fluctuations in the economy in aggregate can arise out of these ''market imperfections.'' This is particularly true for financial markets, which, as discussed in chapter

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4. Automatic stabilizers of the sort discussed in chapter 2 are not in question here or anywhere as a useful policy instrument (even if Japan's are less responsive than many other countries').

5. This consciously differs from the slightly more common statement that macroeconomic policy cannot affect permanently the natural rate of unemployment or the potential growth rate. There is mounting evidence from European unemployment and the ongoing American boom of the 1990s, as well as theoretical models of path dependence and hysteresis, that persistent courses of aggregate demand can have lasting structural effects. This is in addition to the related possibility of macroeconomic policy moving economic confidence and the economy between good and bad states as discussed in chapter 4.

6. For a layman's summary of this view, see Krugman (1994, chapter 8). For more technical surveys, see Blanchard and Fischer (1989) and Romer (1996).

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4, trade in information that is inherently difficult to verify and use rigid contracts and unique relationships (such as bank loans of fixed nominal debt). This is why much macroeconomic research of the last 15 years has come around to verifying the long-held belief that financial markets and their interaction with monetary policy are a primary source of business cycles and their propagation.[7] The fact that such cycles exist, however, does not mean that economic policy can or should do anything about them.

The economic performance of Japan in the 1990s is the perfect illustration that discretionary countercyclical policy is appropriate under certain circumstances. In short, not only is the business cycle not dead in Japan, it has turned deadly. The usual reasons for avoiding discretionary fiscal policy clearly do not apply. The recession has gone on for so long that there is no danger that the lags of decision making and implementation will outlast the downturn. There is no reason to think that the Japanese economy is anywhere near full employment, so fiscal stimulus would not be a misguided attempt to push unemployment below the natural rate. All information and forecasts point in the same negative direction, so there is no meaningful chance that fiscal policy will provide wasteful support for an upswing already under way. There is no question, given the economic and political events of the summer of 1998, that this would be seen as an emergency measure, one to be reversed when times are better, and not as an opening to an ongoing expansion of government.

Nothing in the experience of arguably excessive fiscal activism in the 1960s and 1970s, and disregard for budgetary discipline in the early 1980s, constituted a disproof that under sufficiently severe circumstances fiscal policy is the necessary response. What was proven is that economic policymakers should not attempt to fine-tune the economy, smoothing out every business cycle, and that no one should attempt to permanently raise the rate of employment and growth through fiscal stimulus. ''Coarse tuning'' of the sort called for after seven years of stagnation and now decline in Japan remains important. As Schultze (1992, 213) puts it, discretionary fiscal policy ''is suited for the occasional big effort rather than a continually monitored application of force.''[8] A driver who ends up risking fender benders and wasting time unnecessarily by darting in and out of lanes in normal traffic should stop such behavior—having improved his day-to-day driving, however, the same driver should not forget about the possibility of passing an obstacle on the freeway in order to avoid a serious accident.

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7. Bernanke, Gertler, and Gilchrist (1998) review the state of research. Bernanke (1995) and Calomiris (1993) discuss the critical role of financial factors in the Great Depression.

8. Krugman (1994, 32) similarly observes, ''But remember that [fiscal expansion] is not by any means an all-purpose policy recommendation; it is essentially a strategy of desperation, a dangerous drug to be prescribed only when the usual over-the-counter remedy of monetary policy has failed.''

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The willingness to engage in discretionary fiscal policy in a clearly identifiable economic emergency must not be lost in the rush to meet arbitrary budget rules, such as the European Union's post-EMU stability pact or the Japanese government's revised promise to limit budget deficits to 3 percent of GDP by 2005, any more than the driver who normally follows the speed limit must not forgo the possibility of accelerating to well beyond 55 miles an hour in certain rare circumstances for safety's sake. Buchanan and Wagner (1977) influentially argued that myopic voters will be unable to feel the future tax bite of deficit-financed public spending, so removing a strong barrier against budget deficits, even for good countercyclical reasons, will lead to spiraling debt.[9] Yet, as seen in table 2.1, there is no connection between the extent to which (combined discretionary and automatic) fiscal stabilization offsets cyclical swings and the size of a country's government sector. A similar lack of connection exists with the level of government debt.

As representatives of the well-known fiscal-responsibility advocate, the IMF, pointed out, ''Keynes' *General Theory* opened the door for the Keynesian practitioners in government to recommend 'functional finance,' that is the use of deficit spending to iron out cyclical fluctuations in the economy. However, sizable and persistent deficit spending only started in the 1970s, when the influence of Keynesianism was waning'' (Masson and Mussa 1995, 6).[10] Alesina and Perotti (1995) establish that in the OECD from 1960 to 1990, governments were three times more likely to initiate a loose fiscal policy in recession years than in nonrecession years, meaning that cyclical factors, not boundless political demands, are an important determinant of budget policy. ''Conversely, during a recession governments are about 2.5 times *less* likely to carry out a strong adjustment . . . very tight fiscal policies initiated in nonrecessionary years are twice as likely to be successful [i.e., lead to sustained reductions in government debt] than those initiated during recessions'' (Alesina and Perotti 1995, 21). The appropriate use of fiscal stabilization, actively pursued only during times of clear and present danger as seen in the persistent Japanese downturn of the 1990s, is clearly supported by cross-national evidence. Countercyclical concerns should not be the everyday concern of policy, but they do still matter and should be given their due when the correct dire circumstances arise.

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9. DeLong (1998, 83) sympathetically summarizes their argument: '''Cyclical deficit: good, structural deficit: bad' appears to a message that is just a little bit too hard for the political nation to grasp.''

10. This is a widely recognized pattern (see, e.g., Blanchard and Fischer 1989, chapter 11; Bordo, Goldin, and White 1998, chapter 1), and should be obvious to anyone who observed the rise of *structural* deficits in the 1980s without concern for the business cycle under the Reagan, Thatcher, and Kohl conservative governments.

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National Economic Models Do Not Determine Short-Run Performance

The relative decline of Japanese economic performance against the other members of the OECD in the 1990s, as well as the Asian economic crisis of 1997, have occasioned a reassessment of the ''Japanese economic model.''[11] Some are ready to pronounce a verdict upon that model, because many of the very things praised—relationship banking, close government-business ties, long-term or lifetime employment, cheap capital through low returns on massive pools of savings—seem to be the sources of the crisis. For some commentators who see the US economy riding high at the moment, there seems to be extra incentive for offering such triumphalism, especially because credit was ascribed to Japan (with some explicit Japanese encouragement) for having been the model that other East Asian economies followed to economic success in contrast to the cautionary example of lagging economic performance in the United States in the 1970s and 1980s.[12]

What should be reassessed instead is the very idea that coherent ''national economic models'' are determinants of short-run macroeconomic performance. Even the low methodological standard of those economic analysts who are correctly ridiculed for labeling two similar observations a trend cannot be met when discussing the explanatory power of national models: a supposedly unchanging independent variable (Japan's political-economic system) is correlated with opposite outcomes on two observations (growth in the 1980s, stagnation in the 1990s), and the same can be said in reverse for the United States. Clearly, the difference in performance is attributable to something other than the model. As discussed in chapter 1, it is difficult to point to a change in some external factor that made the Japanese economy, or for that matter any other large developed diversified industrial economy, less viable as a whole in the 1990s, unless that factor changed for all of them at once. If, as I have argued, poor macroeconomic performance in Japan in the 1990s was the result of mistaken economic policies, that is, a matter of choice, the national-model concept has no explanatory power for subpotential growth.

Equally important, the idea that there is an identifiable and stable Japanese model does not really apply. For all the concentration of attention upon the *keiretsu* and Main Bank ties of Japanese industry, there are large parts of the Japanese economy that simply do not fit this idealized pattern (e.g., the eminently successful Honda auto and motor company arose

11. For the most sober and thorough argument in praise of this model, see World Bank (1993).

12. Krugman (1998b) argues against US economic triumphalism on the basis of a lack of change in the fundamental growth potential of the US economy.

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independently of any such *keiretsu* bond). Even before unemployment began to rise significantly in 1997, lifetime employment only applied to a small proportion of the Japanese workforce, primarily older workers at large firms. As reviewed in chapter 3, there is strong evidence that Japanese savers respond to the same sorts of life cycle and precautionary motivations as do savers in the United States and elsewhere.

The deservedly criticized Japanese financial system is more distinctive in degree than type from its Anglo-American counterparts than originally thought. Despite initial evidence that firms with Main Bank ties had longer time horizons for investment and better monitoring and workouts of financial distress (see, e.g., Hoshi, Kashyap, and Scharfstein 1990a, 1990b, 1991), these results proved not to be robust to changes in data sets and time periods.[13] Just as mainstream financial theory would predict (e.g., Myers and Majluf 1984), large Japanese firms that can go directly to capital markets for financing tend to do so at the margin and leave their banking relationships. The different *levels* of bank debt, long-term employment, or savings in Japan than in the United States do reflect a number of real historical and institutional differences between the countries—the fact that these do not represent universal characterizations of *every* entity in the Japanese economy, or determine distinctive *behaviors* at the margin by those entities, means that treating these differences as the basis for using a national model to explain business-cycle swings is misguided.

The demonstrated ability of particular sectors or companies of the Japanese economy to change and adapt further undercuts the idea of a unified national model as an explanatory device.[14] The most articulate and sophisticated proponents of the idea of the national economic model as an explanation for differences in national economic performance work in the political-sociology tradition and tend to view national models as complex integrated systems where the functionality of one segment depends on its relationship with the other segments.[15] If one believes instead that economies are collections of sectoral components (or perhaps even firms and individuals), where one or another can be replaced or altered without throwing off the whole system, the concept of the Japanese economic model as some sort of unified whole begins to break down.

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13. For evidence supporting this revisionist view, see Hayashi (1997), Gibson (1995, 1997), Horiuchi, Packer, and Fukuda (1988), and Yafeh (1995).

14. This is not a claim that the Japanese economy is a shining example of flexibility, adapts quickly, or has no need for structural reform. It simply suggests that there has been change in parts of the Japanese economy and that reform need not be an ''all or nothing'' proposition.

15. The originator of this view is Shonfield (1969). A particularly notable and scholarly example of this systemic approach to the Japanese economy is the collection of papers in Aoki and Dore (1994).

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While the pace of change in Japan in the 1990s leaves many opportunities for improved efficiency, there is no question that change in some sectors has taken place. On the deregulation front alone, retail stores, oil prices, and telecommunications all have been liberalized to a noticeable degree. There has been extensive movement of industrial production offshore from Japan to East Asia and elsewhere, transforming the nature of employment and corporate governance in the same fashion and for the same reasons as it did in every other rich industrialized economy. There is net emigration as well as (by non-US OECD standards) high labor mobility on the part of skilled and young Japanese workers preferring risk taking to the (exaggerated) possibility of lifetime employment.

Financial liberalization began in 1984, long prior to the current ''Big Bang,'' and those early efforts resulted in significant increases in the issuance of securities (e.g., bonds and commercial paper) as alternatives to bank debt. Banking in general is a declining industry, in Japan as in continental Europe, as both savers and borrowers seek better alternatives (although the process is much further along in the United States). The Bank of Japan was granted independence and a clear price stability mandate, just like most central banks around the world, despite decades of monetary policy run by the Ministry of Finance in pursuit of numerous goals. Again, this is not to say that the Japanese economy has come anywhere close to some ideal of free-market liberalization, but that various attributes of it have altered over time. The ''Japanese economic model'' has not constrained change in particular sectors, or for individuals, businesses, and households, in the direction of their counterparts in other industrialized economies.

Explicit comparison to the neighboring economies of East Asia underscores the inability of a monolithic Asian economic model to compete with more general economic explanations of macroeconomic fluctuations. Attribution of these economies' decline in performance to following the Japanese model, or lumping together the causes of Japanese stagnation with those of the Asian financial crisis, is a misleading oversimplification. First, what provoked the financial crisis in Asia and the current banking problems in Japan was a series of financial factors familiar to those who saw not only the crises in Latin America but also the banking problems of the United States, France, Spain, and the Nordic countries in the last decade. It was lack of supervision, regulatory forbearance for banks with low net worth, aggressive lending by those weak banks, and debt deflation—all following a monetary policy tightening—that led to banking problems and financial crises; a common set of economic incentives can account for all of these (see chapter 4; Mishkin 1994; Goldstein 1998). It is one thing to say that the macroeconomic effect of a banking crisis is larger in the East Asian economies because of the relatively large role of connected lending or the low level of transparency—it requires a great

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deal more to say that the crisis is different in *nature*, as claims that recent events reflect coherent Asian versus US national models imply.[16]

Arguments that the United States has benefited from its distinct liberal aspects, especially, I would maintain, in finance and corporate governance are justified, but those are arguments about specific industries and regulations, not about coherent systems or national economic models. It is a matter of adaptation and choice, again, not of an all-or-nothing decision to follow a particular national template. Just as the United States benefited from the adoption of certain Japanese industrial techniques regarding quality, inventories, and worker involvement—and did not have to change its entire ''national model'' to integrate these components—Japan can benefit from certain financial changes (many of which are already promised in the ''Big Bang'') without having to change its entire ''national model.'' In fact, as documented in Posen (1998), there is no relationship between the nature of a country's financial system (relationship-based versus arm's length) and its social cohesion (government welfare spending, distributional equity, absence of conflict, etc.), as should be apparent from the mixing and matching of attributes seen in many OECD countries. Not only does the ''Japanese economic model'' remain as much a mix of good and bad attributes as it ever was, as argued in chapter 1, relying on it to explain short-run economic performance presents a significant conceptual obstacle.

The Creativity of Destruction Is Overrated

Underlying this book's argument has been the assumption that countercyclical macroeconomic policy and structural reform are largely independent of one another. To the extent that there is any relationship between them, it is that in the short run structural reform requires the significant and usually abrupt reallocation of resources (including workers) between sectors, thereby imposing some temporary costs. I have therefore maintained that, for the most part, structural reform in the Japanese economy, as in most economies, can wait for cyclically good or at least not so bad times before being undertaken. In the case of the critical fragility of the Japanese financial system at present, cleanup and reform cannot be postponed, but their short-run reallocative effects should be recognized and, as stated in chapter 5, these effects are an additional argument for accompanying that effort with substantial fiscal stimulus to offset those effects. Further structural reform should be thought of as future opportunities to

16. If one were speaking in terms of a formal model, it is one thing to say that the coefficient on a financial shock is higher in Japan than in the United States, but quite another to say that a different model consisting of differing equations and relationships is required to understand the shock's transmission.

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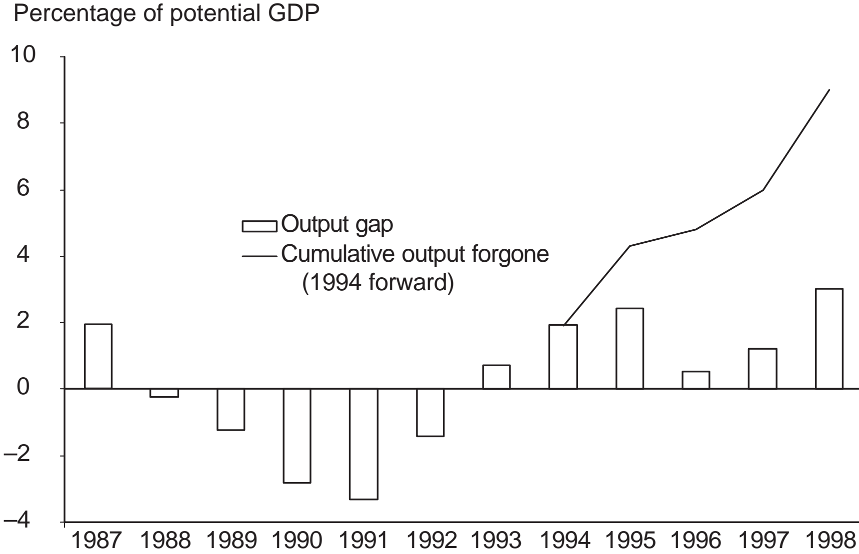
Figure 6.1 Japan's output gap, 1987-98



Note: Output gaps are deviations of actual GDP from potential GDP as a percentage of potential GDP. For further details, see Giorno et. al. (1995). Positive (negative) figure implies below- (above-) potential growth. 1998 figure is forecast.

Source: Economic Outlook, June 1998, OECD.

improve the long-run growth potential of the Japanese economy, and their benefits should not be dismissed. But it cannot substitute for appropriate macroeconomic policy in a time of subpotential growth as obtains in Japan in the 1990s (see figure 6.1 for the output gaps, that is, the amount that growth is below potential each year since 1992).

There is an alternative point of view, common both within and outside of Japan, that claims that there is a strong negative connection between structural reform and macroeconomic policy. In this view, the Japanese recession is itself an opportunity to force the reallocation of resources from inappropriate to more profitable uses—in fact, only a sharp recession or even painful crisis is capable of tearing apart the vested interests and old habits that lock up the Japanese economy in inefficiency. The downturn is caused by that inefficiency and efforts to ameliorate it through macroeconomic policy will stymie the necessary reforms and be counterproductive. To cite two of many examples of this mind-set:

> Like a patient suffering from a slowly metastasizing cancer, Japan can opt for a very painful, though probably effective, course of treatment or accept gradual decline under the numbing influence of monetary and financial sedation. . . . Although undoubtedly painful and unsettling, Japan needs a period of almost revolutionary reconstruction (Asher and Smithers 1998, 5).

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> [A q]uick fix in the form of economic stimulus or fiscal policy . . . meant that fundamental problems are momentarily forced into hiding—where they tend to grow. Without a proper understanding of underlying conditions, these kinds of remedies are at best a palliative, and at worst could hasten the decline they are supposed to prevent (Ohmae 1998).

These views, whether their authors realize it or not, are heirs to an intermittent tradition of what has been called ''overinvestment'' or ''liquidationist'' thinking. These were very loudly put forward in the late 1920s and early 1930s as an argument for inaction on the part of governments in response to the Great Depression, invoking Joseph Schumpeter's famous phrase, ''creative destruction.''[17]

The immense rhetorical appeal of such positions, however, does not constitute evidence in their favor, and more direct support for such analyses is difficult to come by. In essence, they require an act of backward reasoning: if an economy is going through a recession that persists, it must be because the economy is suffering from structural stagnation. Because policy inaction or mistakes are equally good candidates for explaining a persistent downturn on the simple basis that it persists and is bad, be it in the 1930s worldwide or in Japan today, other evidence must be brought to bear. The mere existence of structural rigidities in an economy is not sufficient argument because all economies—even the much touted United States of the 1990s—deviate from full efficiency and can benefit from some forms of liberalization. What is required is some reasoning or evidence that the imperfections are procyclical, that is, exacerbated or at least made more resilient by good growth and wiped away more easily if not automatically by recession.

This turns out to be a much harder case to make on the economies than it may appear. If Schumpeter's much more broadly cited and supported insight—that the source of technological progress and economic growth is the entrepreneurial desire for profits—holds, most companies would seek to form temporary monopolies, or at least oligopolies, whether through patents, brand-name identification, relationships with customers, outright collusion, strategic treatment of competitors, or other methods. And this is exactly what happens in the advanced industrial economies including Japan—businesses emphasize market share, identity, brand loyalty, and even anticompetitive behavior, because that is where the profits are (in any perfectly competitive market, remember, profits are competed away to zero because no one's product is different from anyone else's). In labor markets, the same thing occurs—professional guilds try to establish monopolies, skilled workers try to develop specific skills or training that make them particularly valuable to their employer, people attempt to build reputations and relationships, and so on. While this might sound

17. DeLong (1998) gives a summary of these in the United States in the period.

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like the very sort of rigidity that one would want a recession to wash away, this is actually the engine of economic specialization and development.

These relationships and specializations through the differentiation of products, including the financial information that banks have about customers or the firm-specific training that long-term employees receive, provide benefits that cannot be easily substituted for.[18] A recession is a particularly poor filter for sorting out which relationships and specialized investments should survive and which obstruct reallocation and progress. This is because a recession basically cuts, on the basis of liquidity, across all firms and workers at once. If the markets perfectly rewarded the ''right'' firms and relationships with liquidity and profitability, there would be no need to purge some of these relationships as obstructive. In short, which firms and relationships get put out of business in a recession is rather arbitrary. This point is established formally in models by Caballero and Hammour (1994, 1996), who show that if workers do not have exactly the right incentives to leave current jobs—meaning they are either too strong in protecting their jobs or too weak to demand the proper investment in their training from firms—the result is a recession characterized by lower job creation than job destruction, a rise in unemployment, and inefficiency.

This is, of course, precisely what we see in economic downturns: not just a short lag until the rise in job creation through reallocation matches the rise in workers losing their jobs (as should be the case if the recession is inducing efficiency improvements), but persistently *higher* job destruction than creation.[19] Despite the possible existence of sclerosis, unemployment and job destruction are wasteful. Other evidence is given in the empirical rejection of Olson's hypothesis (1982) that the rise and decline of a nation's economic growth rates can be explained by whether that nation has recently had a cleansing-out of established interest groups (e.g., Japan and Germany had high growth after the war while the United States and United Kingdom did not because the sclerotic institutions of the former were wiped clean by occupation).[20] The OECD (1997a, 21) reports that ''[s]peed of adjustment to regulatory reform can also depend on macroeconomic policy. Excessive macroeconomic fluctuations in the United King-

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18. See the work of Williamson (1985) on asset specificity.

19. See Davis and Haltiwanger (1990) for the original summary of this evidence.

20. The rejection of Olson's 1982 argument had three parts. First, history does not support the premise that Japanese and German interest groups actually were wiped out by occupation and reconstruction. Second, the cross-national evidence on the number of interest groups has no predictive power when put into standard growth equations of the sort discussed in chapter 1. Third, careful study by political scientists of interest group development and economic growth in members of federal unions, such as US states, rejects the interest group hypothesis as well.

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dom in the late 1980s and early 1990s may have delayed the full benefits of structural reforms'' for several years.[21]

One can make a *political* argument that policy change will only take place in a crisis, but the *economic* costs of such a course must be made clear. Returning to Japan, it is important to recognize just how serious the costs of a prolonged recession are even in comparison to the benefits of the most radical structural reform. Even if one were to accept the false contention of the liquidationists quoted above that macroeconomic stabilization inhibits structural change—a contention that I strongly reject—there would still be reason for Japan and all reasonably developed and liberal countries to undertake the proper countercyclical policies as opposed to the structural program. As shown in figure 6.1, the cumulative output forgone in Japan just since 1994, when the downturn had gone on long enough to permit thinking about discretionary policy, is now exceeding 9 percent of a year's GDP.[22] According to the OECD (1997a, 18), ''More heavily regulated countries, which include some European countries and Japan, can expect to see increases in real GDP levels on the order of 3 to 6 percent after ambitious reform programs.''[23] The missed opportunity for Japan of countercyclical macroeconomic policy in the 1990s, in terms of GDP forgone, was on this comparison at least 50 percent greater than the missed opportunity of ''ambitious reform.'' This is not to diminish the importance of political interests in preventing both macroeconomic policy and structural change in Japan, but to say that the stakes of appropriate macroeconomic stabilization policies for Japan are at least as great as those of deregulation.

One can hope that this cost of recession need not be increased in order to persuade Japan to act in its own economic self-interest, as well as that of the world economy. Japanese economic policymakers should restore Japan's economic growth to the rate of which it remains capable. It was mistaken macroeconomic policies, not the Japanese economic model or structural decline, that were the source of Japanese economic stagnation in the 1990s. While the lost output of below-potential growth can never be regained, Japan can achieve rapid growth quickly by following the program offered in chapter 5 or a similar effort at macroeconomic stimulus and financial reform. Regardless of what Japanese economic policymakers decide to do in the late summer of 1998, it is important that students of

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21. It should be noted that the research and writing of the OECD on deregulation has been one of the intellectual engines of the worldwide push to liberalization, so this is hardly a skeptic's assessment.

22. This is based on the OECD output-gap numbers. For a discussion of various means of estimating this output gap, see chapter 1 and the appendix.

23. While this captures only some of the dynamic benefits of deregulation, the output gap does not capture the hysteresis effects of economic growth, so it is best to compare these numbers directly.

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economics and public policy take the right lessons: the business cycle is not dead, but sometimes is deadly; national models do not determine short-run economic performance, macroeconomic policies and corporate decisions do; and, in economic terms, recession-driven economic destruction is simply destructive, so governments should try to do something about it.

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