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Japan's Economy Needs Freedom

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The Japanese economy can come back stronger after the current crisis. But only if it has more freedom.

The destruction in the wake of Japan's massive earthquake, tsunami, and nuclear crisis is expected to exceed \$300 billion, although even that huge figure can't take into account the loss of life and the suffering from this tragedy. Japan's people are resilient and will once again show the world the will to rebuild their island nation. In doing so, however, they need to rethink their economic growth model and restructure their institutions to increase economic freedom and allow for 'creative destruction.'

Some analysts have argued that Japan's natural disasters create a unique opportunity to rebuild, generate economic growth, and eventually increase wealth. Yet, one shouldn't forget how much better off Japan would have been without those disasters. Instead of replacing a destroyed home or factory with a new one, Japan could have used the same resources to add to its existing capital, and experience a net increase in real per capita GDP.

But unlike natural disasters, which always destroy wealth, the free market constantly shifts resources from less to more highly-valued uses as determined by consumers. Labour, capital, land, and other scarce resources naturally flow to where they are most profitable from consumers' viewpoint. Jobs are created and destroyed in the process. But the newly created jobs for labor and capital have a higher value to consumers than those lost; hence, the term 'creative destruction,' coined by economist Joseph Schumpeter.

Following World War II, Japan was 'ruthless in getting rid of inefficient industries,' according to Herman Kahn in his classic book *Japanese Superstate*. But Japan also built a new industrial state that eventually led to crony capitalism, protectionism, and corruption; and for the last two decades Japan's growth has been stagnant.

Despite numerous attempts to stimulate the economy by government spending, the only result has been the accumulation of a large national debt. The politicization of investment decisions—fostered by the cozy relations between government, firms, and banks—has led to inefficiency and low returns on capital. The savings of the people have been squandered as their deposits in Postal Saving Banks earn low interest and are channeled toward projects sanctioned by government and special interests, not the free market.

The best and the brightest often choose an easy life in the bureaucracy and then go on to lucrative jobs in the very industries they were regulating. Competition is stifled, and there's little incentive to follow Hong Kong's model of 'small government, big market.'

In 1980, Japan ranked number 12 out of 144 countries in terms of economic freedom; today it ranks 28th, as measured by the Fraser Institute's Economic Freedom of the World index.

What Japan needs is a new way of thinking: a transition away from government dominated institutions that have led to stasis toward free-market institutions that lead to an expansion of choices and wealth creation. What is needed is a move from 'Japan Inc.' to a real private free market in which consumers, not bureaucrats,

are sovereign. There is increasing evidence that supports the link between economic freedom and wealth creation. That shouldn't be a surprise: when people have private property and can trade freely, their range of choices increase, and they become better off.

Japan's highly educated work force and work ethic needs to be nurtured by institutions that allow for freedom and adaptability so resources can create new wealth rather than destroy or redistribute existing wealth. That means limiting the size and scope of government and depoliticizing investment decisions. Capital freedom, sound monetary policy, and fiscal responsibility can help Japan regain its economic strength. Pegging exchange rates, erratic monetary policies, and government largesse would do the opposite.

In the days ahead, the Japanese people will face the challenge of emerging from disasters that have inflicted enormous losses. In doing so, they also have the opportunity to rethink their economic model and to mold new institutions that recognize the importance of 'creative destruction' in adapting to the natural forces of the marketplace.

James A. Dorn is vice president for academic affairs at the Cato Institute and editor of the Cato Journal.

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