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Political Economy shaped by Financialization

Impacts on Monetary Policy and Foreign Economic Policy of Japan

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June 2023

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Abstract

Financialization has, in the last several decades, touched many aspects of political economy, intensified politics of distribution and redefined power struggles around the world. Nonetheless, the style and types of financialization and its manifestation in both domestic politics and foreign policy vary greatly among different economies depending on financialization and the important role of financialized wealth both to sustain corporations and savers (especially in rapidly aging population like Japan for the pensioners). Despite its comparatively low level of financialization among the OECD members, the phenomenon have had visible influence in shaping the Japanese government's role both in its monetary policy through the Bank of Japan (BOJ) and for its external geoeconomic strategy of infrastructure investment financing in competition with China's Belt-and-Road Initiative (BRI) since 2013. I argue in this report that due to the rising level of financialization, the Japanese government has faced increased pressure to adjust its policies to accommodate the demands of market-based financial interest, on the one hand, and to direct the country's financial power for its foreign policy goals, on the other hand. The developmental legacy of Japan's institutions, however, continues to influence the government's financial strategy.

Keywords

Financialization, monetary policy, infrastructure investment, Japan, OECD, derisking

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Political Economy shaped by Financialization: Impacts on Monetary Policy and Foreign Economic Policy of Japan

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Introduction

Financialization is defined as “the increasing role of financial motives, financial markets, financial actors and financial institutions in the operation of the domestic and international economies (Epstein 2005, 3).”¹ This phenomenon discussed around the industrialized countries in the West has touched many aspects of political economy, intensified politics of distribution and redefined power struggles around the world in the last several decades. Notwithstanding the validity of such generalization, the style and types of financialization and its manifestation in both domestic politics and foreign policy vary greatly among different economies.

Comparing OECD members in the late 1990s into 2000s, Japan ranks relatively low in various measures of financialization ranging from household debts to gross financial income among the non-financial corporations (Karwowski et. al. 2020). The Japanese economy through its catch-up industrialization process and war mobilization since the late 1930s has relied heavily on bank-based indirect finance rather than the market-based direct finance (Hoshi and Kashyap 2001), and such tradition continues on into the 21st century (Hattori 2020). As a result, the reliance by the firms and the households on market-based financial assets, equity and stock investments, has been much more limited than those of the US or UK economies. Nonetheless, financialization and the important role of financialized wealth both to sustain corporations and savers (especially in rapidly aging population like Japan for the pensioners) has had visible influence in shaping the Japanese government’s role both in its monetary policy through the Bank of Japan (BOJ) and for its external geoeconomic strategy of infrastructure investment financing in competition with China’s Belt-and-Road Initiative (BRI) since 2013. I argue that due to the rising level of financialization, the Japanese government has faced increased pressure to adjust its policies to accommodate the demands of market-based financial interests, on the one hand, and to direct the country’s financial power for its foreign policy goals, on the other

¹ Epstein’s definition is the most cited definition of financialization. The other two well-cited definitions are: “The accumulation of wealth through financial channels instead of through trade or commodity production (Krippner 2005: 174),” and “A process through which all the elements of national demand bear the consequences of the dominance of finance” (Boyer 2000, 121). Source, Mader, P., Mertens, D., & van der Zwan, N. (2020, 7).

hand. The developmental legacy of Japan's institutions, however, continues to influence the state financial strategy.

In this report, I analyze two issues, the impact of the stock market volatility on monetary politics and the source of Japan's quality infrastructure investment strategy, which were the topics of my research during my FFJ/Banco de France fellowship in 2022-23. Developments of both monetary policy and infrastructure investment have been influenced by the process of financialization in Japan in the 21st century. By examining monetary politics, I can demonstrate how financialization and the importance of the stock market stability influences domestic politics directly, while infrastructure investment case is interesting as the government has incentive to utilize its strategy in support of financial interest without much tangible success. In both cases, Japan is a good subject for research as it is a "hard case" given its relatively low level of financialization, at the same time, Japan has a comparatively long history of conducting both the unconventional monetary policy and quality infrastructure. I acknowledge, nonetheless, that these two are only a few example of interesting developments both internal (rise of Private Equity, for example (Schaede 2022) or external (failure of internationalization of the yen, for example). Nonetheless, this is one attempt to connect financialization dynamics to strategies and choices of the Japanese government.

Following this introduction, the report reviews the level and characteristics of financialization of the Japanese economy through both comparative and chronological perspectives. In this process, the report reviews how Japan's post-war industrialization and export-promotion drives via "developmentalism" and with reliance of the developmental state has influenced the process. The next section covers the dynamics of monetary policy and how the BOJ became sensitive to stock-market volatility since its de jure independence in 1998. The following section turns its focus to the role of the government in channeling financial power of Japanese private sector and assets to overseas infrastructure investment that would (a) enhance the Japanese government's influence in the region, and (b) potentially accrue higher returns on the investment (compared to keeping the funds in Japan).

1. Financialization of Japan

The level of Japan's personal wealth expanded quite dramatically in the late 1980s at the time of the country's asset bubble and stock market boom to the extent that Japan then recorded the highest national wealth per adult among the G7 countries in the early 1990s. With the burst of its economic bubble since then, however, the growth of personal wealth stagnated to the levels of UK and Italy by 2020 (Figure 1). Nonetheless, following the same pattern as the other G7 member countries, the growth of wealth in Japan has vastly outstripped the growth of national income per adult (Figure 1). As for the content of the wealth at the household level, the proportion of equity and stocks among the financial assets held by household is much lower than others, where its estimated share of financial assets directly invested in equities is 10 percent in 2021 (BOJ 2021: 2). In contract, the 2021 share of such asset held by households in the Euro area and the United States are 18.2 percent and 37.8 percent, respectively (ibid.). Furthermore, Japanese households' debt to their disposable income is also relatively low at 112 percent between 1997 and 2007 in comparison to European counterparts with 253% in Denmark and 213% in Netherlands (Karwowski et. al. 2020, 966). In terms of Japan's financial sector, it is not very large, either. Its share of gross domestic product (GDP) fluctuated between

4 and 6 per cent from the 1990s through the mid-2010s without clearly trending upwards (Hattori 2020: 299), while others (such as the United States and Australia) are above 7 to 8 percent (Karwowski et. al. 2020, 996).

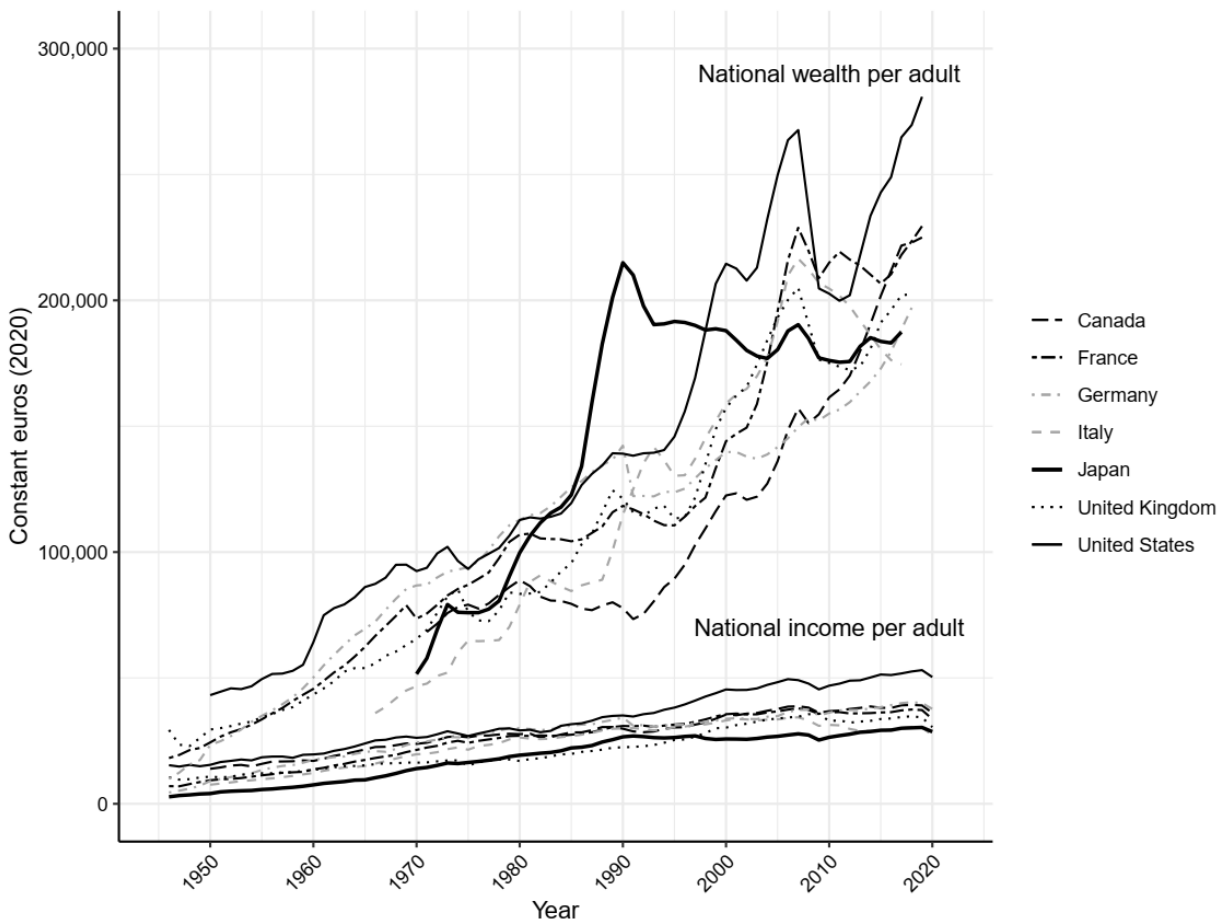


Figure 1. National wealth and income on a per adult basis in G7 countries, 1946-2020. Source: World Inequality Database (WID), various countries and years. Notes: (1) The WID does not provide sufficient data for developing countries, and it only covers a few such as China, Mexico, and Russia. (2) See Chwiero and Walter (2019a, 9) for a broader comparison that encompasses 15 OECD countries.

Nonetheless, the importance of return to assets in the equity market has also heightened in Japan as we enter the 21st century due to several reasons. First, due to the country’s rapidly aging population, the Japanese government has faced critical challenge regarding the sustainability of Japan’s pension scheme. In the deflationary environment (discussed below) of the country, it has become imperative for the Japanese government to boost return on the pension fund investment. Particularly during Prime Minister Abe’s second term under Abenomics, Japan’s Government Pension Investment Fund (GPIF) invested much higher ratio of its portfolio (from 15 percent to 25 percent) into the stock market (Katsu 2020). Second, after winding down Japanese *keiretsu* corporations’ stock-crossholding (*kabu mochiai*) in the 1990s under severe recession (Miyajima and Nitta 2011), profit-seeking investors increased in number and began to demand higher return rather than the stability in the market.² Third,

² Nishiyama (2021) reports that in the early 1990s, about 70 percent of the investors in the Japanese stock markets were so called “policy-oriented stock holding” investors, who sought long-term market stability through cross-holding of

financial liberalization has led to a large increase of foreign investors in Japan's stock market in the 21st century. Not only about 30 percent of stockholders in Japan are non-Japanese, but when it comes to the volume of trading, almost 70 percent is conducted by overseas investors (Fujinami 2022).³

In sum, there has been intensification of financialization pressure in Japan in the last several decades due to demographic pressure and structural changes in Japan's corporate governance and financial market, although the relative level of financialization has not been as high as other G7 economies. Given the traditional developmentalism drive to mobilize capital through indirect finance (i.e. banks), such institutional underpinning has perpetuated slow pace of financialization helped by stagnant economic growth.⁴

2. Japan's monetary policy and its connection to financialization

Japan's prolonged recession and its deflation since the late 1990s drove the BOJ to become the first central bank in the post-World War II to implement unconventional monetary policy including the asset purchase programs (Park et. al. 2018). This provided an opportunity for scholars to evaluate connection between financialization and unconventional monetary policy, the connection which has risen to the concerns (Boyer 2000). Choosing Japan as a case has some methodological advantages, as it proves to be the most unlikely case especially among the G7 countries with its somewhat unique and must less pronounced level of financialization. Meanwhile, a long(er) duration of its unconventional monetary policy allows more data points to examine forces behind BOJ's asset purchase decisions.

Our ongoing research (Cheung et. al. 2022) examines the BOJ's decisions to purchase stocks as a part of its asset purchase program, and the role of the legislatures in such process. By examining the relationship between Japan's stock market performance and the BOJ's monetary policy choices since its 1998 *de jure* independence when the data on BOJ summons to the Japanese Diet and details of discussions on monetary policy became available, we have analyzed how the decline in stock market has affected (a) the amount of legislatures' pressure on the BOJ, and (b) the BOJ's decision to purchase Exchange Traded Funds (ETF) since the late 2010. With the data on frequency of BOJ summons to the Diet, and the amount of ETF purchases interacted with the summons, we are able to evaluate how the stock market volatility has influenced the BOJ's policy choices. Our research posits two empirical findings.

First, the regression analysis of the impact of the monthly stock market performance on the BOJ summons by the Diet committees has shown that the more severe the stock market decline, the more likely it is for the legislature to summon the BOJ leadership asking them to explain the Bank's monetary policy. In addition to this quantitative result, the transcripts from the Diet committee meetings show that, especially at the time of dramatic stock market decline such as the 2011 triple disaster, the elected politicians were explicit in demanding the BOJ's actions in

stocks, while the remaining 30 percent were the profit-seeking investors. In 2021, this ratio flipped where 67.1 percent of investors are now profit seeking.

³ For the data, see Japan Exchange Group (<https://www.jpx.co.jp/markets/statistics-equities/investor-type/00-02.html>).

⁴ For criticism of recent literature on finance that ignores the bank-based and market-based finance system, see Braun and Gabor (2020, 243).

stabilizing the stock market. Second, such pressure imposed by the legislature at the time of stock market decline would lead the BOJ to purchase more ETFs as evidenced by the significant impact that the interaction variable of the BOJ's Diet summons on the BOJ's ETF purchases since late 2010s, when this program started. Our approach is different from the analysis conducted by Katagiri (et. al. 2022) that examines the impact of the ETF purchase on the market risks.

The BOJ's exposure to legislature's pressure has its roots in its post-independence history since 1998 where the call gradually intensified with the aim of "taming deflation" (Park et. al. 1998) and against BOJ's apparently "stubborn" insistence of monetary orthodoxy (in the face of very unorthodox conditions). The political pressure and the emphasis on the ETF purchases by the BOJ was clear from the Diet discussion at the time of the Covid-shock in March 2020 even the then-Prime Minister Shinzo Abe clearly stated that further ETF purchases were needed to stabilize the stock market.

From my in-person and online discussion with the researchers and scholars from France about this research before, during and after the Banque de France-FFJ workshop on 6th December 2022 (from hereafter "the workshop"), I highlight the following comparative aspects of monetary policy as relevant for my further study.

First, and partly due to my political science perspective, the research I and my collaborators have conducted has focused on what has influenced the BOJ's monetary policy and how. In other words, monetary *policies* as a result of monetary *politics* has most often been the dependent variable of our research with the focus on political dynamics. Even very consequential programs of the unconventional monetary policy started from political decisions. Meanwhile, my conversations especially with the Banque de France (BdF) economists revealed that their interest focuses on the impact of the chosen program on the economy. For example, there has been robust research conducted by the BdF economists on the impacts of asset purchase programs on portfolio rebalancing and corporate debt structure (Lhuissier and Szczerbowicz, 2022). Furthermore, the impact of central banks' unconventional monetary policy goes beyond corporate decisions. Depending on the central bank's mandates, such impacts clearly extend to a broader economic issues such as income equality (Saiki and Frost 2014), and even the foundation of democracy (van't Klooster, 2021, for example).

Second and in relation to political and democratic foundation of central banking, our research work casts an anti-thesis on central bank accountability literature (Best 2016, for example). As pointed out by Eric Monnet during the workshop, the scholarly concerns on central banking developed since the surge of central bank independence literature focuses on the central bank accountability via principal-agency framework (Tucker 2019, for example) or democratic control considerations (Monnet 2023). In the case of Japan, the article 54 of the new BOJ law enacted in 1998, which requires the BOJ top officials to be accountable (i.e. provide accounts and being responsible) to the legislature, has led to high level of pressure on their policy autonomy. It is particularly the case when the legislatures maintain the power to revise the founding laws of the central bank and often flaunt such power as a threat (Dwyer 2012). The story of politicization of the central banking (Moschella forthcoming Chapter 5) involves interests and actions of legislatures. Such pressure coming from legislatures was most visible during the years under the Prime Minister Abe's second term (December 2012 to September 2020) when the Abe administration used economic boost through Abenomics for

its political goal especially toward constitutional revision and conservative political consolidation (Lechevalier and Monfort 2018).

Third, it is essential for this type of research to seriously consider variety of financialization. From Bremer and Chwioroth's paper (2022) presented at the workshop, the comparative analysis regarding the public views on the central bank's unconventional monetary policy, we see that type of individual's asset holding, especially mortgage position, sways one's views on monetary policy. The ongoing monetary policy discussion around the world, as many central banks unwind their post-Covid reflationary measures, demonstrates highly distributive implications of unconventional monetary policies. It would be important to examine the politics of not only the installation of unconventional monetary policy but also the unwinding of this policy at varying time period. Furthermore, the role of private corporations and their funding structure plays an important role in assessing monetary policy. As discussed above, one of the important facets of Japan's financialization in the 21st century is the changes in the way corporations finance their businesses. Although our research did not dig deep into the lobbying or other actions by Japanese businesses, the direct lobbying does not seem to have shaped the BOJ's policy choices.

In sum, Japan's monetary politics is largely guided not only by the politics but also economic institutions that placed the BOJ in the context of rising financialization under fiscal constraints. Currently, many researchers are evaluating the lasting impact of Abenomics in terms of what has worked and what has not.⁵ Although our research work has demonstrated political influence over BOJ in support of propping up stock market prices, the mechanism and rationale needs to be examined further.

3. Japan's infrastructure investment and financialization

Financialization around the capital rich traditional aid donors has visible impact on development financing around the world. In that, one can see such effects particularly in the aftermath of the global financial crisis of the late 2000s. With the rapid collapse of investment products such as mortgage backed-securities during the crisis, financial pressure in search for alternative investment opportunities mounted. It was in that context that investment in infrastructure as an "asset class" emerged (Inderset 2010; Andonov et. al. 2018). Along with the rise of financial capitalism where the state supporting the political order of "Wall Street Consensus" (Gabor 2021, 431) protected its interest through institutional mechanisms, financialization of development has progressed. As seen in Sustainable Development Goals (adopted in early 2010s and implemented from 2015 through 2030) along with various infrastructure initiatives, development projects have been turned into assets to invest, and then investment into such assets are considered "development finance" consisting not only of governments' funding but also private capital (Mawdsley 2018).

Of course, China's assertive "going global" strategy, particularly through its Belt-and-Road Initiative (BRI) since 2013 with the emphasis on infrastructure development, has also incited geostrategic reactions among the traditional donors (OECD/DAC members). These

⁵ Hausman et. al. (2021) conclude that Abenomics boosted stock market and supported financial market, but it did not lead to increasing consumption. Meanwhile, Bamba et. al. (2021) argue that, by monetizing the public debt, Abenomics sustained fiscal health.

governments began to put emphasis on the quality of infrastructure (rather than the quantity advantage China has had) to compete with China's infrastructure investments around the world. The Japanese government in particular became the most visible promoter of "quality" infrastructure investment after then-Prime Minister Shinzo Abe's announcement of Japan's Partnership for Quality Infrastructure (PQI) investment in May 2015 and had successfully adopted the G20 principles for Quality Infrastructure Investment at the 2019 Osaka G20 summit.

Following the work by Lechevalier et. al. (2019) on the evolution of the state-finance nexus on industrial policies of Japan and Korea, I argued, in my fellowship proposal, that such evolution has also imposed challenges to Japan's geoeconomic strategy. The quality infrastructure promotion represent this challenge where the state is tasked to incentivize private sector and financialized assets to embrace such investment, where the risks are high.

The Japanese developmental institutions used to apply "trinity approach" to overseas development where its government has mobilized private sector to connect aid, investment and trade with the emphasis on building infrastructure around East Asia (Fukuda-Parr and Shiga 2016). But after the 1990s, through economic reforms and in the face of government's exposure to heavy fiscal burdens, Japan could no longer implement this type of "big push" infrastructure funding support in Asia. Instead, the emphasis of "quality," through which private finances can and would get mobilized, has become vital. This would also help in competing in the bidding process against cheaper alternatives supplied by emerging countries such as China, India and in the early phase South Korea. The same (or similar) can be said for other OECD members, where the governments emphasize quality and engage in "de-risking" infrastructure projects especially high-risk low income countries so that they can cope with the "portfolio glut" that these countries have experienced in the last ten years and utilize private financial resources to fill the infrastructure funding gap (Shin 2012; Arezki et. al. 2016).

After conducting interviews with officials and experts in Tokyo, Singapore, Washington DC and Paris before and during the fellowship as well as multiple conversation I had with scholars in Europe as I gave presentations on the topic, I have raised the following questions to revise my research.

First, how closely is Japan following the mode of neoliberal approach and in response to financial sector's pressure in support of infrastructure investment? What is the role of institutional complementarity between Japan's "developmental state" institutions (or at least remaining features of these) and new mode of de-risking private investment? These questions get to the crux of Japan's challenge in quality infrastructure initiative where the government is motivated to take a lead but it has limited institutional capability, both financially and in terms of expertise, to do so compared to the scale that it was able up to the 1990s (Katada 2020). Meanwhile, the private sector still expects the government to lead in the traditional style of "kokyo jigyo (public works)," both domestically and abroad, where the government is held financially and operationally responsible. Hence, private business involvement under public-private partnership (PPP) is still underdeveloped in Japan, and the risk-averse businesses have been hesitant to take on large financial stake in overseas infrastructure investment. In a way, it is *not* the pressure from "below (i.e. the businesses)" that has led the Japanese government to

strive to de-risk infrastructure financing for the private sector. Rather, it is the pursuit of growth and business opportunities led by the government (i.e. developmentalism) underlying this strategy. As this research progresses, it is important to include a comparative analysis not only between China and Japan (as a representative of the OECD country), but also of how Japan's institutional structure and objectives compare to those in other OECD members.

Second, what are the concrete methods of de-risking, how effective are they? The project so far focuses on the rhetoric of “bankability” as the method used by the western governments to de-risk investment in infrastructure. The efforts include establishment of the Blue Dot Network that is now in the phase of implementation with the support of OECD (OECD 2022). This certification network would assess and certify “quality” of infrastructure projects for smooth financing.⁶ There are more hands-on ways to decrease risks ranging from guarantees to equity participation to enhancing governance institutions in the host governments (OECD 2015). Since infrastructure investments are complex and there is vast variety of risks in different types of projects and in a variety of host governments, the analysis of both operations and effectiveness into the concrete measure would require case studies.

Third, can we expand the notion of quality in “quality infrastructure investment” beyond financial criteria? Although there are some benchmark as to how to understand quality in the “quality infrastructure” in the form of bankability, one might want to stretch the envelope in connection to current environmental, social and governance (ESG) challenges facing the world. When it comes to green investment, the concept is already placed in the front and center of the quality infrastructure investment drive by the US and European Union.⁷ In a way, it is not only the way to entice western businesses that have technological advantage in green infrastructure, but it is also a way to avoid “race to the bottom” prospect of infrastructure competition.

Fourth and finally, how can we understand the collaboration and competition among the global north, and where does this lead us? So far, there is a very visible solidarity among the G7 members on quality infrastructure investment starting from the agreement on G20 principles for quality infrastructure investment in 2019 to the G7 support for the Global Partnership for Infrastructure and Investment in 2022 to mobilize \$600 billion. The European Union, in addition, launched the Global Gateway with €300 billion in the global south to fill the infrastructure investment gap. All of them will count on private financiers to engage in funding these initiatives. At the end of the day, however, private companies across those countries are competitors in their respective businesses. How much such competition would be mitigated by openness and transparency included in these quality infrastructure initiatives is not only of scholarly interest, but also of practical concern. On the other hand and for the global south, debt sustainability challenge is emerging. Investment derisking by China and G7 governments could lead to profound moral hazard, which will have long-lasting negative consequences.

⁶ According to the US government, the Blue Dot Network “aims to promote quality infrastructure investment that is open and inclusive, transparent, economically viable, Paris Agreement aligned, financially, environmentally and socially sustainable, and compliant with international standards, laws and regulations.” US State Department website (<https://www.state.gov/blue-dot-network/>).

⁷ See, for example, the speech by US President Biden and President of the European Commission, Ursula von der Leyen, at the G20 side-event on November 15, 2022 (<https://www.whitehouse.gov/briefing-room/statements-releases/2022/11/15/united-states-indonesia-eu-joint-statement-on-partnership-for-global-infrastructure-and-investment/>)

In sum, financialization impact especially after the global financial crisis has spilled over into foreign economic policy among the capitalist west. Japan has taken the lead in promoting quality infrastructure investment to channel abundant and underutilized (i.e. low return) private financial resources to much needed infrastructure investment. Such trend derives partly from financialization of the economy. This has been a successful strategy when it comes to raising diplomatic prominence that Japan attracted. Meanwhile, the actual mobilization of fund is not that easy, and the jury is still out as to how much tangible and positive results the “quality” drive will produce not only for the Japanese economy but for those in the global south.

Conclusion

Financialization has had multiple effects on both domestic economic policies and international geoeconomic strategy. The financial pressure mounting both in terms of politics of its profitable use and wealth protection has been translated into policies of central banks as well as governments’ foreign policy. Although the level of financialization is not as pronounced as other G7 members, Japan has not been immune to such demands. The BOJ was pressured by elected politicians to consider stock market fluctuations and the use of private financial assets has become an important condition behind Japan’s successful quality infrastructure investment initiative.

Nonetheless, political structure and economic institutions of Japan’s “developmentalism” serves as both the baseline of and constraints in translating Japan’s financialization into changing actions. For monetary policy, the increase in financialization over the last several decades along with the new institutional mandates for the BOJ has led it to respond to political “accountability,” which opened a window for more pressure on the BOJ to prop up the stock market at the time of decline. For infrastructure investment, the lingering developmentalism has motivated the Japanese government to proactively engage in de-risking infrastructure investment with the emphasis on quality. Nonetheless, the drive has yet to be accompanied by the enthusiastic support from the private sector.

Finally, it will be important for my future research projects to be more comparative. Not only is the variety of financialization a crucial aspect to consider, but to evaluate Japan and its developmentalist institution in the face of financialization will lead a much broader and insightful research trajectory.

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