The Confucian Model

The system behind East Asia's rise represents an epochal threat to human freedom.

by EAMONN FINGLETON

In April 1998, Sony Corporation chairman Norio Ohga made world headlines with his comment, "The Japanese economy is on the verge of collapsing." In reality, nothing in Sony's experience supported such an assessment. On the contrary, its business boomed right through the 1990s. More generally, Japanese industrial corporations continued to gain share from American rivals. Yet they all talked as if Japan was a hopeless basket case.

Even the president of Toyota Motor, Hiroshi Okuda, joined in, suggesting Japan could cause a "world-wide financial crash." This despite the fact that Toyota's sales soared fully 95 percent in the 1990s. Between 1989 and 2019, Toyota went from little more than one-quarter of General Motors' revenues to nearly twice G.M.'s.

As for Ohga, in the quarterly accounting period when his remark was made, Sony's sales in the Japanese market increased by 14.7 percent. Measured against 1989, the last year of Japan's 1980s boom, Sony's profits in 1998 were up fully 131 percent. As if that weren't enough, the 1990s was the decade when Sony finally buried once-formidable American rivals such as Motorola, RCA, and Zenith.

This is cognitive dissonance on a vast scale. What was really going on? In truth, Japan's alleged economic disaster of the 1990s was a fake funk. Japanese leaders just pretended their economy was collapsing. There was method in their madness: They desperately wanted Washington to cut Tokyo some slack in trade negotiations. This was a time when Americans had never been more incandescent about Japan's closed markets. The gambit worked—in spades. Not only did Washington back off trying to open Japan, it has never subsequently really tried.

The issue of Japan's true performance is of first order historic importance because of its implications for, 1) the rise of China, and 2) the coming triumph of authoritarianism around the world. China runs about twenty years behind Japan, as is obvious in, for instance, the global car industry. This means it has a lot of technologically easy catch-up growth ahead of it. Combine this with the fact that China boasts four times America's population (and eleven times Japan's), and it is hard to exaggerate how dominant Beijing will be by 2050.

Both China and Japan operate essentially the same authoritarian—and almost universally misunderstood and underestimated—economic model. Let's call it the Confucian model.

Invented in the desperately poor circumstances of early 1950s Japan (and thus a memorable instance of necessity playing mother to invention), the Confucian model has long been powerfully shaping economic outcomes in South Korea and Taiwan as well as, of course, China and Japan. The model's function is to force-feed the growth process.

We will discuss some of the Confucian model's key features in a moment. First, let us note that this model is incompatible with American hopes for a global rollout of free markets. There are two immediate problems:

1. The Confucian model is not only protectionist but unalterably so. Aspects of the model cannot work without a protected home market.

2. The Confucian model features a complex latticework of corporate structures that clearly conflicts with American free market capitalism. Not the least of these structures is cartels, which are, of course, strictly forbidden under U.S. law. Another problem is Japan's *keiretsus* and other similar corporate groupings (known as *chaebols* in South Korea, *qiye jituans* in China, *quangxi jituans* in Taiwan). As we will see, such structures are undoubtedly on balance helpful in improving East Asian productivity.

The Confucian system makes considerable use of markets and this, of course, encourages hopes in Washington for a general trend towards greater freedom in East Asia. In reality, officials throughout the region claim the right to overrule market forces almost at will. They often use cartels and *keiretsus* as power vectors that help them reach deeply into the system's internal workings. "Undesirable elements" quickly discover that there is nowhere to hide.

To understand the Confucian system, the best starting point is its savings strategy. If a nation's savers save more, corporations can invest more. If corporations invest more, workers can produce more. (Whereas in the United States corporate leaders focus on profits, almost to the exclusion of everything else, in East Asia worker productivity gets priority.) Equipped with the most advanced production machinery, such as robots in the car industry, nations can quickly leap to the forefront in productivity. Economic growth is thereby stimulated.

Of course, savers need a return, and here is where protectionism is so important. Corporations earn super-high profits in the home market and these are then applied to looking after the various sources of capital. Meanwhile, producers can aggressively cut prices in export markets.

For an economy to keep growing, savers must keep saving. This is where the Confucian model really comes into its own. The model's most important—and most counterintuitive—feature is its savings process. With few exceptions, American observers assume that culture is sufficient to explain the region's super-high savings rates. Supposedly, Confucianism instills in everyone a powerful tendency to frugality.

This does not fit the facts. In former times, when East Asian nations

Xi Jinping speaks at Boeing's Everett, Washington facility.

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seemed more Confucian than they do today, they were often notably weak savers. Japan's savings rate remained low well into the 1950s. Singapore, South Korea, and China followed a similar pattern, with low savings rates as late as the 1960s, 1970s, and 1980s respectively. It is only when East Asian nations begin to adopt other aspects of the Confucian model, in particular its aggressively mercantilist trade policy, that their savings rates take off.

Behind all this is a policy virtually unheard of in modern America: suppressed consumption. To anyone tutored in modern American economic thought, the idea of suppressing consumption may seem to border on insanity. But that is not how things look in modern East Asia.

Nor is it how things looked to U.S. economic planners in World War II. Soon after Pearl Harbor, the United States began tightly suppressing consumption. The program started with rubber tires, and was later extended to cars, sugar, typewriters, and gasoline. By the end of the war, rationing covered coffee, shoes, stoves, meats, processed foods, and bicycles. Lo and behold, the result was a preternatural increase in the savings rate. According to the economist Laura Nicolae, U.S. households' excess savings during the war totaled nearly 40 percent of national income.

In modern East Asia, the effort to suppress consumption is less direct but equally effective. For a start, East Asian governments restrict the import of key consumer products. Another important strategy is to minimize consumer credit. Mortgage finance is largely or totally unavailable in many parts of the region. Credit cards are also hard to come by. This point is often missed because American correspondents conflate debit cards with credit cards. According to Fitch Ratings recently, fewer than 30 percent of Chinese adults had at least one credit card, compared to 79 percent of Americans.

Meanwhile, in many East Asian nations, zoning is so tight that housing is rendered stunningly expensive. Restricted living space means consumers consume less electricity and gas. They also buy fewer appliances and items of furniture. Other ways of suppressing consumption include barriers to imports and limits on foreign vacation travel.

Now let us consider the Confucian model's approach to employment, the area where East Asia diverges most obviously from American capitalism. As a matter of etiquette, major East Asian employers do not hire from direct competitors. Moreover, they rarely resort to lay-offs, even in the worst recessions. This creates by default a settled system of long-term employment.

Orthodox American economists regard East Asia's no-layoffs policy as "inefficient," but the region's passionately patriotic government officials see things differently. Any calculation of the benefits to society from American-style hire-and-fire should, they believe, be netted for the cost to the public purse of unemployment benefits.

The psychological advantages that accrue to employers from a no-layoffs policy are a lot more beneficial than is understood in modern America. East Asian workforces feature a far greater degree of long-term accountability. They are also impressively strong on teamwork. Because the East Asian employment system expects employees to commit for the long term, there are rarely second chances for employees who fall out with their first employer. That means that workers are considerably more cooperative in taking on tough assignments. Certainly East Asian employers enjoy the observed advantage that at all times they have at their disposal battalions of hard-working employees willing to be sent anywhere and do anything to further their employer's agenda.

Another advantage of the East Asian system is that it provides employers with a much greater incentive to invest in worker skills. American employers have to worry that any workers they train may be quickly hired away by rival employers.

In recessions, East Asian employers beat the bushes to find work for their workers. They will even go to the extent of inventing busywork, but generally things don't get that bad. Even in a recession, East Asian corporations rarely run out of useful work to do.

There is a big difference in the way that labor costs must be accounted for. In the terminology of the accounting profession, wage costs count as a fixed cost for East Asian employers, whereas they are a variable one for American employers. This has crucial implications, because so long as variable costs are covered, East Asian corporations can keep discounting their prices. Hence in large part the reason why in a recession they can quote almost preternaturally low prices. The degree to which East Asian corporations can cut export prices and still come out ahead is greater than Americans typically understand.

Faced with the never-undersold nature of East Asian competition, American employers often enter a process of terminal shrinkage. They slash jobs in a recession but rarely fully restore these in a recovery. Instead many resort to outsourcing, which they consider to make particular sense in the early, tentative stages of a recovery. A devastating ratchet effect is therefore at work in which over the long haul the Americans keep losing market share.

In withstanding a global recession, East Asian companies have an important cushion in undervalued home currencies. Put another way, the U.S. dollar has long been massively overvalued. Just how overvalued is suggested when you consider America's forty-year record of huge trade deficits. How low would the dollar have to go before we might see a revival in industrial investment? A reasonable guess is that even a devaluation of as much as 75 or 80 percent would not have an appreciable effect. Yet a revaluation on this scale would imply that total U.S. gross domestic product would at a stroke be cut to less than China's and even Japan's. No presidential administration is likely to contemplate such a haircut.

Meanwhile, the big exporting nations—including Germany as well as China and Japan—will probably for several years to come continue to prop up the dollar as a quid pro quo for continued access to the American market. These nations' top priority is not financial but rather industrial. They aspire to continue to hone their production skills. The super-long production runs provided by an open American market are an important help in this regard.

Perhaps the most troublesome structure from an American point of view is cartels. American economists agree on few things, but they all seem to agree that cartels are bad. Cartels not only cheat consumers but featherbed inefficient industrial processes, or so orthodox American thinkers vociferously proclaim.

In East Asia, the view is different. East Asian cartels are quasi-regulated institutions answerable at all times to the national interest. Yes, members of such cartels fix prices, but they can't shut down all forms of competition. Rather, cartel members are generally encouraged to compete on quality and service. As for unrestrained free-market pricing, this is seen as wasteful because it diverts executive attention away from the weightier matter of delivering ever higher quality at ever lower production cost. The problem of gimmicky pricing incidentally can be particularly acute in the most capital-intensive industries, which are precisely the industries with the best prospects of creating well-paid rank-and-file jobs going forward.

Another advantage of cartels is in standard setting. In former times, industrial standards typically originated in the United States. Not anymore. Most standards these days emerge from East Asia. This is important because those who set standards tend to favor their own interests.

Then there is perhaps the most important advantage of these cartels: They reduce the cost of research and development. Cartel members divide up research projects among themselves, thus minimizing duplication. This feature alone may make all the difference, as it is not unusual for leading manufacturing corporations elsewhere in the world to spend as much as 5 percent of sales on research and development. East Asian cartels get far more innovation for their money, and this benefit is passed on to each member.

Much more could be said, but it should be clear that the United States desperately needs to take a closer look at the Confucian model. The conclusion is epochal. A system that rivals Soviet communism in its grim suppression of individualism is now powerfully outperforming American free-market capitalism. The outperformance is most obvious in international trade. On closer examination, the Confucian system's superior wealth-creating capabilities are evident almost across the board.

In short, we are witnessing a fundamental revolution in the human condition. The world is transitioning from an era when free societies did well precisely because they were free, to a new era in which authoritarian societies are doing well precisely because they are authoritarian.

In one sentence, authoritarianism is set to inherit the earth. ■

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