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William M. Tsutsui
Hendrix College

Stefano Mazzotta
Kennesaw State University, smazzott@kennesaw.edu

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The Bubble Economy and the Lost Decade: Learning from the Japanese Economic Experience

William M. Tsutsui and Stefano Mazzotta

This paper presents a concise overview of Japan's economic development since World War II, with a particular emphasis on the speculative boom of the 1980s known as the "bubble economy" and the subsequent period of economic stagnation known as the "Lost Decade." The essay is largely descriptive. It provides an historical contextualization and interdisciplinary synthesis accessible to readers from a wide range of backgrounds, including those with limited formal expertise in economics.

Introduction

Over the past century and half, the Japanese experience has often been held up as a salutary lesson for other nations and cultures. In the late 19th and early 20th centuries, Japan was heralded as the first (and for many decades only) example of a non-Western nation to embrace industrialization, capitalism, and the constellation of political, social, and cultural values considered modern by the powers of Western Europe and North America. After World War II, Japan's rapid economic recovery from defeat and occupation made it a model of liberal democracy and of market-based growth for developing nations around the world. After the end of the Cold War, as Japan seemed poised to eclipse countries like Britain and the United States industrially and financially, it was increasingly regarded as an object lesson for the once-formidable powers that had become complacent and inflexible economically. Today, however, the world seems to have few tips to take from Japan on economic glory or the secrets to national success; instead, Japan's experience since 1990 seems only to hold sobering warnings of how not to handle economic booms— and the inevitable busts— of the challenges of reversing long-term economic decline and of opportunities lost and promise unfulfilled.

This article provides a concise overview of Japan's economic path since World War II, with a particular emphasis on the speculative boom of the 1980s (known as the bubble economy) and the subsequent period of economic stagnation and national drift, often referred to as the Lost Decade, even though it has stretched on for almost a quarter century.[1] The analysis is light on statistics and rigorous economic theory, but heavy on the kind of description, historical contextualization, and interdisciplinary synthesis that should make it accessible and useful to readers from a wide range of backgrounds, including those with limited formal expertise in economics. The article first presents a succinct summary of the postwar Japanese economy, what was widely thought of in the West as the "miracle economy," and the industrial, financial, and political system that carried Japan from

[1] This essay builds upon Tsutsui (2009, 2010).

postwar impoverishment to being the second largest economy in the world over the span of less than 50 years. The focus then turns to the bubble economy of the late 1980s— what caused it, what sustained it, and what impact it had on Japanese society— before moving to an examination of the bust that came in 1990 and the long period of economic frustration, political indecision, and social crisis that followed it. The essay closes by briefly surveying the economic situation in Japan today and considering several fundamental questions for all observers of Japan over the past 25 years: how did Japan go so wrong economically? Why hasn't the nation been able to extricate itself from an ongoing, seemingly endless, economic hole? What lessons does the Japanese experience hold for us in the United States today? Or, even more simply put, how does the United States avoid becoming the next Japan?

From Devastation to "Miracle"

At the end of World War II, Japan was almost literally bombed back to the Stone Age. Hiroshima and Nagasaki had been obliterated by atomic bombs and almost all of the other major Japanese cities, including Tokyo, had been devastated by American air raids. At the end of the war, Japan looked like a lost cause economically: unemployment was sky high, inflation was raging at triple digit levels, food was in short supply, the raw materials necessary for industry were not available (and in any case, most factories had been taken out of action by American bombing), agricultural production was slumping, and the overseas markets for Japan's exports had all been lost in the defeat. Not surprisingly, many experts in the American Occupation forces that took charge in Tokyo in 1945 felt that Japan should just give up on having a modern economy altogether. Its industries should be scrapped, some argued, and Japan should prepare for a future of subsistence agriculture.

For all this pessimism in the ruins of war, Japan economic potential in 1945 was far better than it appeared. Prewar industrialization and wartime mobilization had left Japan was with a stock of well-educated, diligent workers, as well as deep experience with modern industrial production. For instance, 10 out of the 11 major auto manufacturers in postwar Japan were products of the war years. In addition, three of them, namely Toyota, Nissan, and Isuzu, prospered as the primary producers of trucks for the military during the war. Japan also had in place extensive financial and transportation infrastructures, and perhaps most importantly, a populace and a government absolutely committed to building up their nation again (see e.g., Dower, 1992; Dunscomb, 2014; Gordon, 2013; Koo, 2009; Mak, 1998; & Pesek 2014).

The situation was stabilized during the American Occupation, which lasted up to 1952.[2] And although recovery was slow and painful at first, by the 1950s the Japanese economy appeared to be back on track. The Korean War was a significant impetus to growth: Allied military procurements pulled the Japanese economy out of its postwar doldrums and spurred manufacturing. Japan regained a foothold in international trade, thanks largely to American sponsorship, and most of the overseas markets lost during the war were once again regained. Investment in industry and the introduction of the latest

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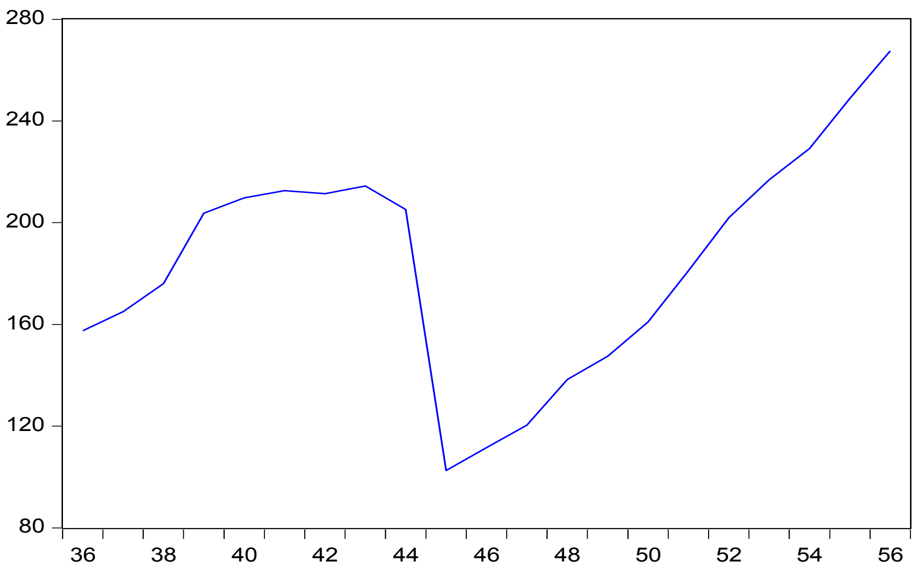
[2] On the economic history of Japan during U.S. occupation see e.g., Dower (1999). On Japan's economy during the high-growth period from the 1950s through the 1970s, see e.g., Johnson (1982) and O'Bryan (2009).

technology from abroad (such as the now-infamous case of the transistor, licensed for a song from America's Bell Labs by Sony) proceeded briskly.

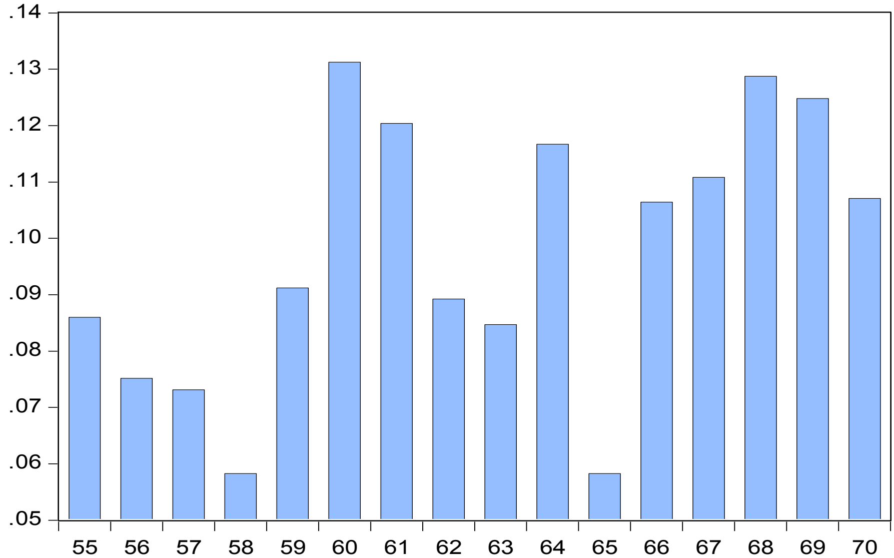
As illustrated in Figure 1 and 2, by 1954, Japan had regained prewar levels of economic activity; by 1956, the Japanese government could brashly declare that "the postwar period is over." Japanese national income grew at an average rate of 9.1% a year in the late 1950s and by the 1960s, the real heyday of what would become known as the "miracle" economy, annual growth averaged over 10%. Although such figures have now become commonplace in rapidly industrializing nations like China, the speed and duration of postwar Japan's economic expansion was unprecedented internationally at the time.

Figure 1: Japan Yearly Gross Domestic Product (in Billions 1990 Geary-Khamis dollars)



Data source: Bolt & van Zanden (2014)

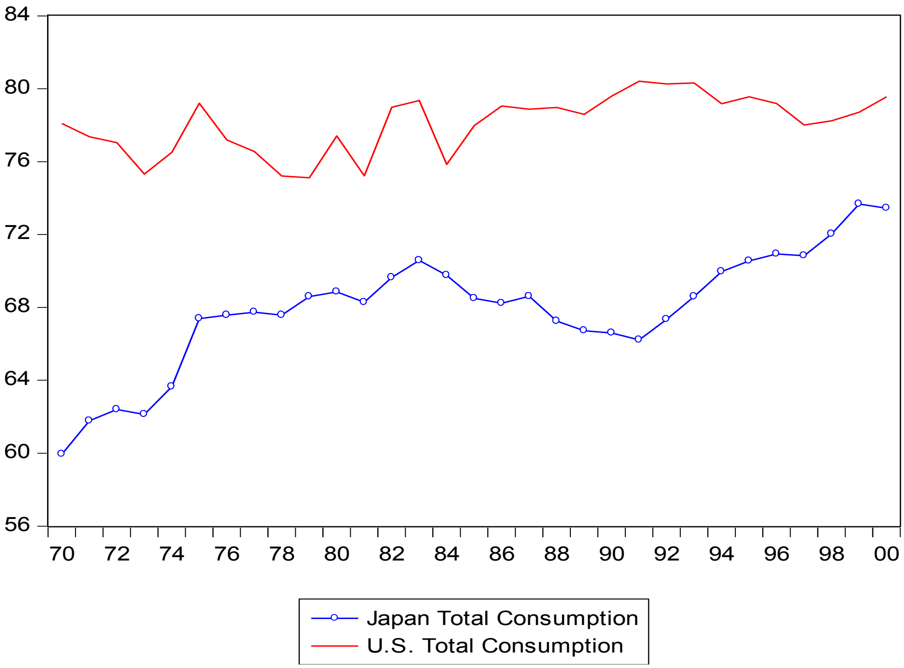
Figure 2: Japan Gross Domestic Product Growth Rate. Period 1955-1970



Data source: Bolt & van Zanden (2014)

Many elements contributed to what is often called Japan's "high-growth economy" of the 1950s and 1960s. Some analysts have focused on Japan's international trade policy, which was said to depend upon closed markets at home and aggressive export drives abroad. Others have emphasized the contributions of Japan's human resources—its dedicated workers, talented managers, and cooperative union members -and many have accused the Japanese of getting a "free ride" on the path to prosperity, avoiding high defense spending by sheltering comfortably under the American nuclear umbrella during the Cold War. Without doubt Japan benefited from the open postwar world trading system, which gave the nation easy access to markets internationally, essential raw materials (especially oil), and the latest technology. Entrepreneurship and innovative corporate leadership also played an important role, as ambitious, risk-taking companies like Honda, Sony, and Nintendo created new industries and revolutionized existing ones. In recent years, increasing numbers of scholars have begun to acknowledge that a long overlooked factor in Japan's "miraculous" growth was consumption: while the Japanese are often seen as the world's greatest savers, they have also proven to be among the globe's most enthusiastic spenders. This was particularly the case in the decades after World War II, when Japan's consumers, compensating for the hardships and deprivations of the war years, purchased at unprecedented levels. Figure 3 and 4 show the distinct growth pattern of Japan vis-a-vis the United States in total and household consumption as percentage of GDP from 1970 to 2000. While U.S. consumption has always remained greater than Japan's it is noteworthy how during the 1970s and the 1990s the higher growth of Japanese consumption helped to significantly reduce the gap.

Figure 3: Total Final Consumption Expenditure, etc. (% of GDP), 1970-2000



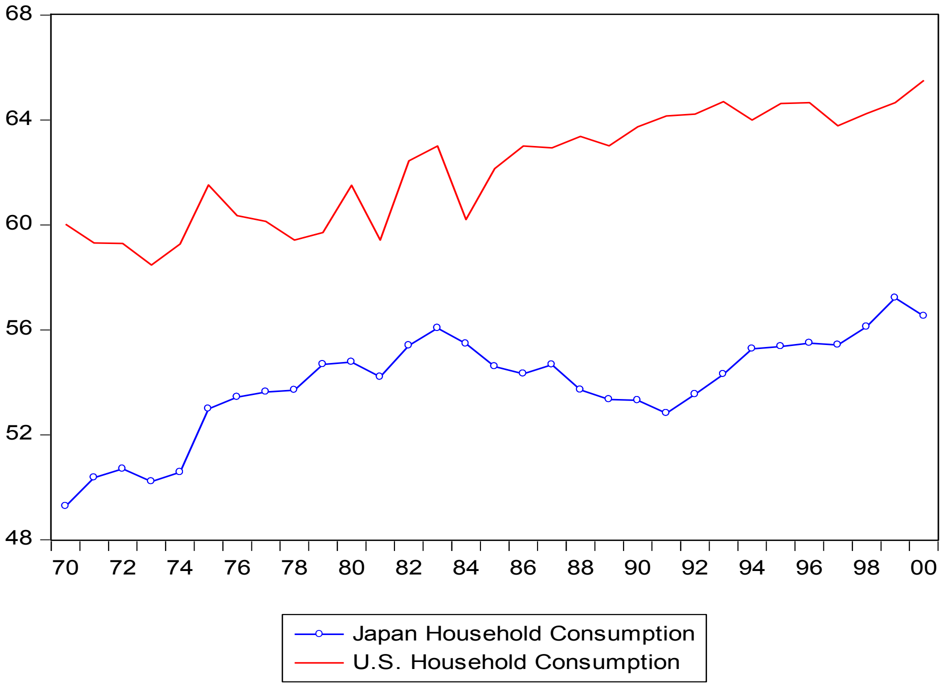
Data Source: World Bank (2014)

Looking back at the decades of high-speed growth, commentators have frequently stressed the important role of certain unique structural features of the Japanese economy, essentially a constellation of distinctive ways of doing things in Japan that supported extremely rapid industrial expansion. One of these features was prominent role of the national government bureaucracy in postwar Japanese economic life: state "industrial policy," charted largely within the Ministry of International Trade and Industry and carried out cooperatively with major corporations, provided a strategic plan and central guidance for Japan's industrial and financial ascent. Johnson (1982) chronicled the economic activism of Japanese bureaucrats and described Japan as a "developmental state," very much a prototype of the kind of governments that have characterized high-growth Asian economies like Singapore, South Korea, Taiwan, and even China in more recent years. Other Japanese institutions linked with rapid growth include the "Japanese Employment System" (comprising the practices in large firms of lifetime employment, seniority wages and promotions, and company unions); the *keiretsu,*[3] loosely organized business networks

[3] The characterization of the relationships among companies within the *keiretsu* and the economic benefits of the system are the subject of numerous studies. See e.g., Grabowiecki (2006) for an introduction. Briefly, the six keiretsu: Mitsui, Mitsubishi, Sumitomo, Fuyo, Dai-ichi Kangyo, and

centered on banks; a distinctive corporate finance system after the war in which bank loans, rather than funds raised on equity or bond markets, provided the bulk of corporate investment needs; a "dual economy," with a small number of large, modern firms coexisting with a multitude of smaller, less efficient family enterprises; and "Japanese-style management," with its emphasis on quality, close collaboration between workers and management, and innovative production techniques.

Figure 4: Household Final Consumption Expenditure, etc. (% of GDP), 1970-2000



Data Source: World Bank (2014)

An often overlooked element in Japan's successful formula for growth was the strong social consensus that supported economic development in the decades after 1945: the Japanese people embraced GDP growth as the prime national goal and were willing to

Sanwa were organized horizontally and comprised several dozen corporate members including a main bank, other financial institutions, manufacturing firms, and a main general trading company. Within each group, companies held each other's shares, and managers held multiple roles and invested in joint research and development ventures. Vertical keiretsu were organized by industry: automobile, electronic, and other industries. For instance, Nissan, Toyota, Hitachi, Matsushita, and Sony are examples of vertical keiretsu.

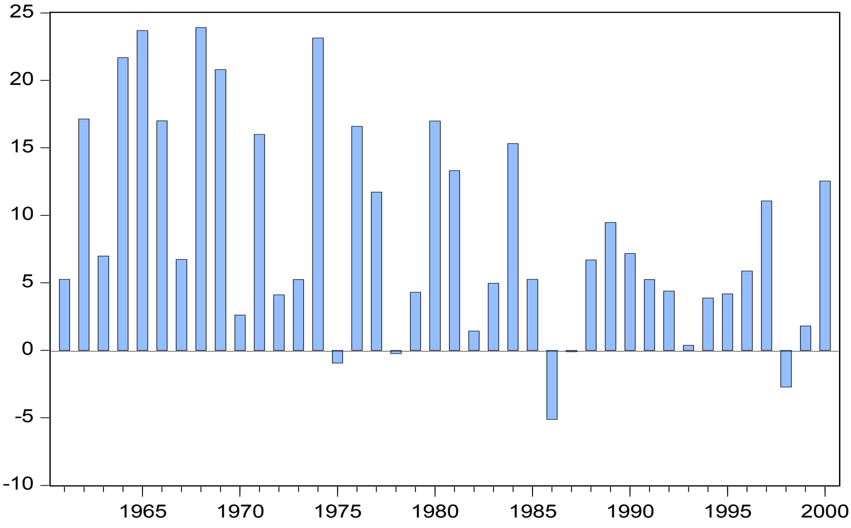
make the sacrifices both in living standards and in the responsiveness of their political leaders, just to name two, necessary to realize unprecedented growth rates.

Pride ran high in Japan when the nation's postwar achievements, from the rebuilding of war-scarred cities to technological marvels like the Shinkansen bullet train, were showcased to the international community at the 1964 Tokyo Olympics and Expo '70, held in Osaka. Yet despite swelling material wealth and national confidence, Japan's 20-year run of unabated economic expansion came to an abrupt and unsettling halt in the early 1970s. The OPEC oil embargo of 1973-74, known in Japan as the "oil shock," brought the high-flying but resource-poor Japanese economy back to earth with a jolt. Seemingly overnight, falling oil supplies and exploding energy prices spurred intense inflation and meant the end of eye-popping economic growth. The first industrial downturn Japan had experienced since the Korean War led to widespread hand-wringing and a heightened sense of the nation's vulnerability in an unpredictable and apparently hostile world.

As it turned out, Japan's economic recovery from the oil shocks was rapid and strong. The engine of Japanese resurgence was exports (see Figures 5, 6, and 7), and most of the automobiles, VCRs, and Sony Walkman that revived Japanese industry were bound for the United States. U.S. consumers, though also reeling from the oil crisis, clamored for fuel-efficient Japanese cars, while buyers worldwide came to appreciate the high quality, sophisticated design, and competitive prices of Japanese electronic goods. In 1974, Japanese-U.S. trade was essentially in balance; by 1976, America's trade deficit with Japan reached about $4 billion; by 1978, $10 billion; and by 1985, it exceeded $40 billion. The annual growth rate of Japan's national income slowed in the late 1970s from the heady heights of previous decades, yet hovered consistently around 5%, a figure that was more than just respectable in an era of American "stagflation" and pallid global growth.

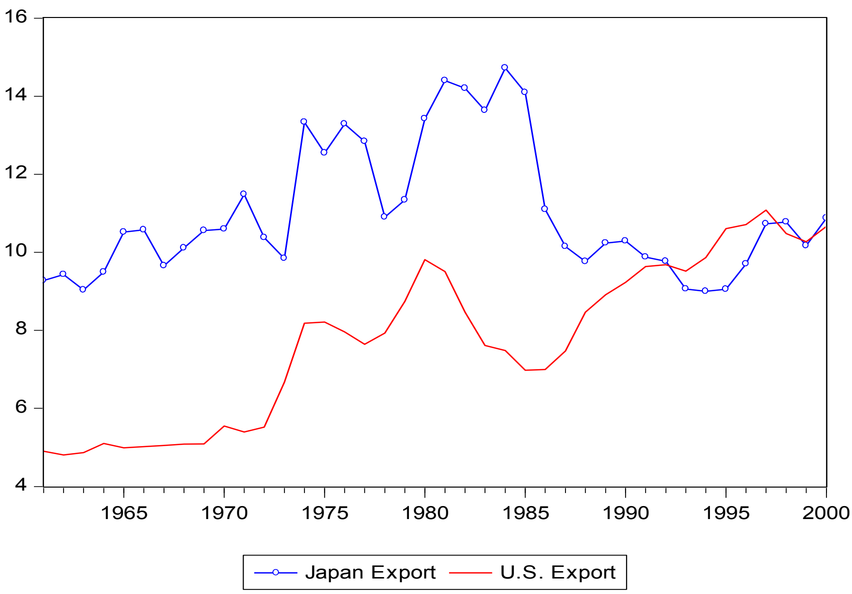
Although Japan's economic rebound thus proceeded briskly, the political and social repercussions of the end of the high-growth era were more profound and long-lasting. The collapse of the "miracle" economy was accompanied by the demise of the society-wide consensus on economic growth as the overriding goal of national policy and personal ambition. In place of this unified commitment to industrial and financial development, a welter of new concerns, interests, and agendas rose to the surface of political and social discourse in 1970s Japan. Mass protests and new social movements proliferated, many of them expressing outrage at the long-overlooked costs of Japan's unfettered growth and the government's feeble response to mounting social and environmental problems. The oil shock and this rising chorus of discontent also took the shine off Japan's political establishment and particularly the conservative, pro-business Liberal Democratic Party (LDP) which dominated national politics from its formation in the 1950s. The party faced declining electoral results from the 1960s, although it managed to cling to power tenaciously. The Liberal Democrats did belatedly embrace a range of progressive social welfare policies but they continued to be seen by many Japanese as unresponsive, out of touch, and pervasively corrupt.

Figure 5: Japan Export Growth Rate, 1961-2000



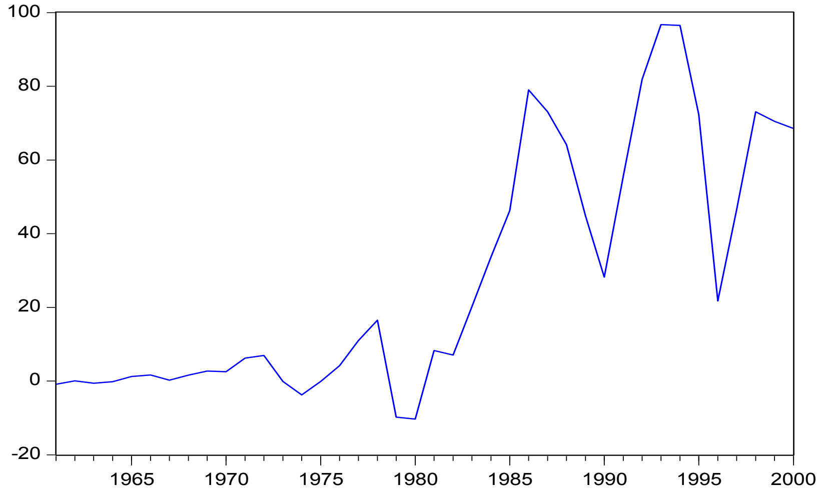
Data source: World Bank (2014)

Figure 6: Export as Percentage of GDP, 1961-2000



Data source: World Bank (2014)

Figure 7: Japan External Balance on Goods and Services (current US$ billions), 1961-2000.



Data Source: World Bank (2014)

The Bubble Economy

After the swirl of domestic and international tensions of the 1970s, the 1980s proved to be exhilarating times in Japan. As the Japanese economy surged forward, especially after 1985, the nation's ascent toward global economic primacy seemed inevitable: the Japanese were widely celebrated as the wealthiest, best educated, and longest-lived people in the world; many commentators heralded of the end of the "American century" and the start of a new Pacific one, with Japan in the lead; as the Berlin Wall fell and the former superpowers took stock of generations of furious military spending, pundits joked that the Cold War had, ironically enough, been won by Japan. Their coffers buoyed by a stock market and real estate boom at home, Japan's corporations and financial titans went on a buying spree abroad: $80 million for a van Gogh, $850 million for Rockefeller Center, $3 billion for Columbia Pictures, and $900 million for the Pebble Beach Golf Course. Japan's financial institutions were the largest in the world; Japanese manufacturers like Toyota were applauded (and widely emulated globally) for managerial innovations; the few moated acres of Tokyo's imperial palace, real estate experts concluded, were worth more than all the land in Canada combined; the 240 square miles of Tokyo were said to be worth more than all the land in the United States combined.

The late 1980s were a dazzling and exuberant moment in Japanese history. To some, the extraordinary affluence of the time led to excess: critics bemoaned the conspicuous consumption and luxurious lifestyles of the urban elite, as well as the corrosive effects which such wealth was having on the values of Japanese youth. Social polarization also became an issue for the first time since the end of the war: fortunes made overnight on the stock market or in real estate speculation meant that Japan was no longer the relatively egalitarian, middle-class society of the high-growth era. Internationally, Japan's stature on the world stage seemed to rise as quickly as the skyscrapers being constructed in Tokyo. Even though Japan would be criticized during the First Gulf War of 1990-91 for its "checkbook diplomacy," contributing money rather than troops to the Allied cause, Japan's economic might and its generosity with aid funds in the developing world earned it increasing global clout. This unaccustomed international influence and the nation's mounting wealth seemed to go to the heads of some Japanese commentators. In widely read books like *The Japan that Can Say No* (1989), penned by Sony founder Morita Akio and conservative politician Ishihara Shintarō, opinion-makers sought to celebrate Japan's cultural heritage, champion a foreign policy independent of the United States, and stoke resurgent nationalist sentiments. Japan, it seemed, was on top of the world and Morita and Ishihara were not alone in encouraging the Japanese to flaunt their nation's success.[4]

As would only later become apparent, the prosperity of those charmed times was built only on the shakiest of financial foundations. In the wake of the Plaza Accords of 1985, which sought to correct Japan's chronic trade surplus by weakening the dollar and strengthening the yen, the Bank of Japan pursued an expansionary monetary policy to prevent recession. This expansionary policy led to a speculative boom in real estate and equities, which gave rise to fierce competition in the banking sector, which, in turn, fueled reckless lending practices. This was exacerbated by changes in the corporate finance system: by the 1980s, Japanese corporations were growing too rapidly to finance all their capital needs from bank loans so increasingly firms like Toyota found their financing in the Tokyo bond market (and in New York and London as well); this meant that Japan's big banks lost some of their biggest customers and were desperately looking for new places to invest their money (and this often ended up being with risky borrowers in questionable real estate deals). In short, the Japanese boom of the late 1980s was really little more than a financial house of cards, a false paradise of paper profits or, as it has since come to be known, a "bubble economy." Despite important differences between collapse of the Japanese bubble and the global financial crisis of 2008 both crises demonstrated how the naive belief that real estate valuations would perennially increase could not possibly hold true. When the bust came, and Japan's over-inflated speculative bubble popped, the impact on Japanese politics, society, and culture, not to mention its economy, was little short of devastating.

As is always the case, finger-pointing is a popular spectator sport in the wake of economic crisis. And in Japan's ill-managed boom of the late 1980s and resounding bust of the early 1990s, there was plenty of blame to go around. In the swelling of the speculative bubble, greed was an undeniable factor, as was good old corruption. A long history of cozy relationships between regulators and regulated in the Japanese financial sector meant that government bureaucrats were beholden to bankers and brokers, and consequently were willing to turn a blind eye when huge profits were on the line. Due to the peculiarities of the Japanese corporate governance system, stockholders also lacked the

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[4] Interesting journalistic surveys of Japan in the bubble economy and the Lost Decade are Kerr (2001) and Pilling (2014).

motivation and the means to provide the necessary oversight of firms driving (and benefitting from) the growing bubble. The high profile of Japan's organized crime groups (the *yakuza*) in property dealings in the high-flying 1980s stoked the speculative fires as well. Japan's central bank, the Bank of Japan, has often been singled out for its consistently inept management of the Japanese economy and the financial sector: while it is easy to fault policy in retrospect, the Bank certainly should have recognized the scale of the bubble earlier, should have intervened sooner to cool speculation and control expectations, and should have used a gentler hand to restore order and discipline to the financial markets. Above all, perhaps, the finger of blame should be pointed at the widespread, tenacious, and (as it turned out) utterly incorrect belief that Japan was somehow different from other economies, that land prices would never fall in Japan, that somehow Japan did not operate by the normal rules of neoclassical economics and so, no matter how large and hazardous the bubble grew, everything would somehow work out well. This irrational faith in Japanese economic exceptionalism afflicted bureaucrats, bankers, property developers, media commentators, and the general public alike, and blinded an entire nation to a financial time-bomb set to explode.

The Lost Decade

The inevitable collapse of the "bubble economy" was sudden and stunning. On the Tokyo Stock Exchange, the Nikkei index, which had soared to 39,000 in the last heady moments of the 1980s (hitting its all-time peak on the last day of trading in 1989), had withered to 14,000 by 1991 and bottomed out at 8,000 just over a decade later. Real estate prices traced a similar trajectory: in the early 1990s, over the span of just 30 months, Japanese investors and landowners saw $2.5 trillion in the value of their assets simply disappear. Commentators described the 1990s as Japan's age of "vanishing wealth," when a generation's worth of capital creation could disappear in a matter of weeks. The crisis which began in the financial and real estate markets quickly sent shock waves through the entire economy. The growth rate fell precipitously from 3.1% in 1991 to 0.4% in 1992 and 0.2% in 1993; in 1998 and 2001, Japan actually experienced negative growth. Corporations retrenched, pruning expenses, shedding redundant workers, and moving high-cost production overseas, especially to China and Southeast Asia, where labor expenses were low. This led to swelling ranks of unemployed workers, something unheard of in Japan since the tough days of the occupation. The official unemployment rate topped 5.5% in 2003, although economists estimated that the actual rate was closer to 9%. The banking sector was especially hard hit by Japan's economic woes, as financial institutions were saddled with a huge volume of uncollectible loans after the real estate bust had demolished collateral valuations, and the 1990s witnessed a disheartening series of bank failures, reorganizations, and mergers. In comparative terms, Japan's economic stagnation was startling: for example, Japan's share of world GDP peaked in 1991 at 9%; in 2010 it had shrunk to just over 6%. In terms of relative standards of living, in 1991 Japan's real per capita GDP had reached 90% of U.S. levels; by 2001, Japan had tumbled to 76% of the American standard.

Japanese manufacturing—once the pride of the economy—did not escape the downturn that began in the financial and real estate sectors: burdened with excess capacity from an overly optimistic investment boom in the 1980s, industry has had to scramble to prune expenses, shed redundant workers, and move high-cost production overseas, especially to China and Southeast Asia. Export industries—electronics, automobiles, machinery—continued to be bright spots in the overall economic picture for Japan, yet these extremely efficient, technologically sophisticated sectors made up only a small portion of the larger Japanese economy (and, ironically, have been among the sectors most aggressive in moving production abroad). Many firms and industries in Japan—small manufacturers, the service sector, construction, distribution, and retailing—are not competitive by international standards and their productivity often lags behind American benchmarks by 50% or more. In single-family home construction, for example, Japanese productivity is only about a third of U.S. levels, largely due to the lack of standardization. The vast majority of Japanese homes are still built using the traditional post and beam method, where there can be up to 150 different dimensions instead of standard lumber sizes (such as the 2 x 4). Such inefficiencies pervade the sheltered domestic sectors of the Japanese economy.

Despite some reports to the contrary, especially prevalent in the American media, the Japanese government did not simply stand back and fiddle as the Japanese economy burned. Indeed, over the past 20 years, the Japanese state has experimented with all the time-honored fiscal and monetary remedies to pull the economy out of recession. But for all the textbook solutions that Japan’s politicians and bureaucrats have come up with, the Japanese economy has consistently proven itself stubbornly unresponsive. For instance, over the 1990s, the central government heartily embraced the Keynesian prescription for a slump, ramping up public works spending and injecting waves of new money into the economy. Such fiscal stimulus did have short-term positive effects, but no matter how many new and often unnecessary bridges, dams, and highways the government created, long-term economic revival remained elusive. To make matters worse, while Keynesian treatments were thus largely ineffective in jump-starting economic growth, they had the effect of saddling Japan with a toxic legacy of national debt. After decades of chiding the United States for its fiscal irresponsibility, Japan came to face an even direr situation. Two decades of flat tax revenues and desperate pump-priming spending left the Japanese government deeply in the red: as of 2009, Japan's gross national debt was approximately 180% of its GDP (and today easily exceeds 200%), while its annual budget deficit was about 9% of GDP, and debt maintenance costs ate up around 12% of the central government’s total annual expenditures. This level of indebtedness is, in relative terms, the highest in the industrial world today and is potentially destabilizing for the global economy over the long term (see e.g., Hansen & Imrohoroglu, 2013).

Monetary policy was also used, in generally conventional ways, to try and rouse Japan from its economic funk. But like an expansionary fiscal policy, turning on the spigots of easy money (to the extent that the Bank of Japan has regularly pegged overnight interest rates at zero percent—that is to say, free money for banks) also failed to inject new life into the moribund Japanese economy. And while the low interest rate policy allowed the government to manage the huge national debt burden, it also caused tensions in other parts of the economy and society. Low interest rates, for example, put considerable pressure on the large and growing population of retirees, many of whom are dependent on interest income from savings accounts. Insurance companies and pension funds were squeezed as well. By 2001, six big insurers and more than 100 pension plans had gone belly up, unable to sustain guaranteed 5-6% payouts on the miniscule returns they were realizing on investments.[5]

Overseas commentators have often singled out the banking sector (and the Japanese government's modest and halting efforts to address the mountains of bad debt accumulated there) as the root of Japan's slow recovery from the bursting of its economic bubble. Even in the darkest days of the Lost Decade, Japan continued to claim several of the largest banks on the globe (at least on paper), yet analysts agreed that virtually all of Japan's banks were technically insolvent, although a tangle of arcane accounting procedures and lenient government regulations kept them legally afloat. As recently as the turn of the millennium, independent observers placed the value of bad or dubious loans on the books of Japanese banks at 100 to 150 trillion yen (or up to a trillion to a trillion and half dollars).[6] Such figures added up to 20-30% of Japanese GDP, which means quite simply that Japan's banking crisis was unprecedented among major industrial nations. In the U.S. savings and loan debacle of the 1980s and 1990s, by comparison, bad loans only totaled about 5% of American GDP. And while the actual costs of the 2008 Wall Street financial crisis are yet to be fully appreciated, the extent of the bad debt rooted in subprime mortgages seems unlikely to have gone beyond 10-15% of U.S. GDP at the time.

Price stability is generally considered a favorable environment for economic growth. Deflation coupled with the liquidity trap, i.e., the ineffectiveness of monetary policy, is a nightmare of economic policymakers worldwide, but a recurrent specter that has haunted the Japanese economy on and off since the collapse of the bubble. Despite the false appeal of lower prices, deflation results in lower revenues for companies which are forced to delay investment and hiring. Sliding prices reduce sales and tax receipts, wage growth, and profit margins. In addition deflation increases real term debt burdens of companies and governments. Deflation became almost routine in contemporary Japan Financial assets and real estate have been deflating for over two decades, and consumer prices have been generally been falling since 1997 (due at least in part to deregulation in industries like telecommunications and wholesaling, which has led to cheaper long distance rates and the availability of lower priced consumer goods, often imported from China). What has terrified economists is that, from time to time, a deflationary spiral has appeared to be setting in, with not only prices dropping, but also wages. Over much of the last decade, average annual salaries for Japanese workers have been declining, as have the average number of hours worked per year. Bonuses, traditionally a significant part of the average Japanese employee's total compensation, have been shrinking particularly rapidly; many firms, rather than slashing workers, have resorted to cutting back on bonuses across the board. All this means that households have seen their discretionary incomes reduced and domestic demand has fallen; this translated into reduced sales for Japanese businesses, increased pressure to lower prices, and further incentives to reduce costs through layoffs or even steeper reductions in salaries and bonuses. Thus the spiral intensifies and the economy grinds deeper and deeper into recession. Economists have debated whether Japan has ever actually slipped into a full-blown deflationary spiral, but the fact that this has even been open to debate shows just how dire the situation has been.

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[5] See e.g., Bell (1997) Nakamoto (2008); Strom (2000).
[6] See e.g., Sanger (1998).

So what went wrong in the Lost Decade and the ongoing years of economic drift in Japan? Why haven't the bureaucrats, the politicians, or the banks or Japan's industrial leaders been able to get a handle on the nation's economic problems and turn things around? Even if there are no simple answers, several factors have clearly contributed to the systematic paralysis and institutional failures of the past quarter century.

As in the making of the bubble, government incompetence certainly played a role in Japan's inability to right itself economically. The Bank of Japan and the Ministry of Finance responded sluggishly at the start of the crisis, wishfully thinking that the economy would naturally correct and the financial problems were not as bad as they seemed. The government also behaved ham-fistedly when, in 1996, it hiked the consumption tax in a desperate attempt to get a handle on runaway national debt. Japan had been mounting a modest but promising economic rally prior to the tax increase, thanks to government stimulus spending and easy monetary policy, but the large and sudden tax hike snuffed out the recovery. The other occasion over the past 25 years when the Japanese economy seemed to be picking up momentum was from 2006 into 2008, when increasing demand from a booming Chinese economy buoyed Japanese exports. In this case, though, it was not bad public policy that doomed the upturn, but instead the subprime-mortgage-driven destabilization of the American financial system that dragged down Japan's economic hopes.

After the global financial crisis of 2008, the American media was particularly outspoken in arguing that the Japanese government did not act decisively enough to clean up the red ink in the banking sector left by the bubble economy. Tokyo, pundits suggested, should have done what the George W. Bush and Obama administrations did on Wall Street and rapidly pumped huge amounts of public money into the Japanese banks to stabilize the markets, clear bad debt off the books, and keep the funds flowing through the financial system. Some of this criticism is on target. The Japanese authorities were indeed slow to address the bad debt issue, and only really supplied the volume of funds necessary to start clearing banks' balance sheets of unrecoverable loans and overvalued real estate well after the start of the new millennium (in other words, more than a decade into the crisis). But some Japanese commentators have protested that these American jabs are unfair and even hypocritical. The Bank of Japan and the Ministry of Finance, the Japanese media has noted, responded to the bursting of the bubble with policies that many American economists and journalists were advising at the time: let the market handle the problem in the financial system, let banks that can't make it fail, allow the system to adjust and the strong to survive, limit the intrusions of the government (which just needs to manage the downturn with classic fiscal and monetary policy), as flooding public money into the banks will just keep the market from operating efficiently, and eventually things will work out.[7] Obviously this strategy did not work out and Japanese policymakers are justified in their frustration at being demonized by American critics who offered one prescription for Japan's financial ills in the 1990s and a totally different one after the Wall Street bail-out in 2008.

Japan's political leaders deserve a good deal of the blame for the morass of the Lost Decade. The LDP, racked by scandal, internally fragmented, and vacillating on recovery policy, finally imploded in 1993, losing hold of the government leadership for the first time

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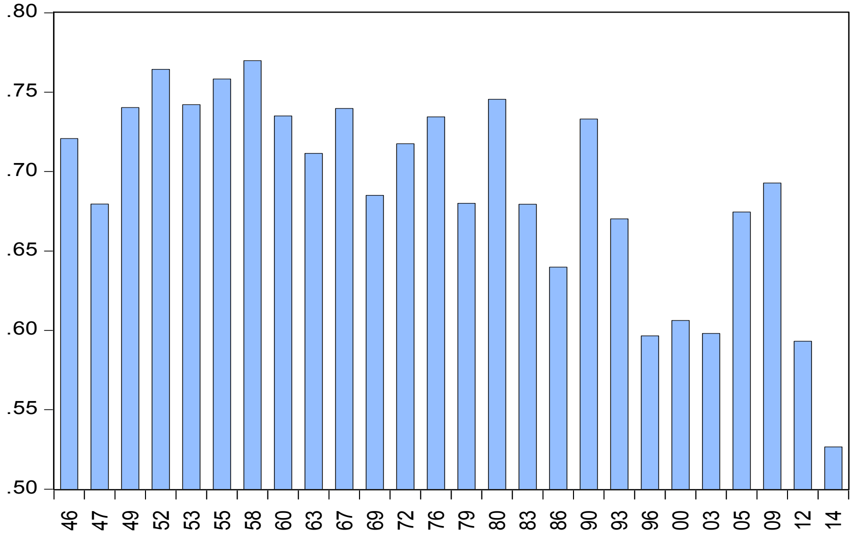
[7] On Japan's economy and society in the new millennium see e.g., Chandler, Heang, & Salsberg (Eds.) (2011).

since 1955 and ushering in a period of political instability just when Japan needed a firm hand at the helm of state. Even though the LDP was able to limp back into power after two and a half years, it lost power again from 2009 to 2012 when the upstart Democratic Party of Japan briefly (and generally ineffectively) ran the country. In short, politics in Japan have been disturbingly volatile. Between 1989 and 2014, Japan has had 18 prime ministers (for an average term in office of just over a year). Several departed under the cloud of scandal, one (Hata Tsutomu) lasted only two months in the job, another (Obuchi Keizō) died while in office, two self-proclaimed reformers (Hosokawa Morihiro and Murayama Tomiichi) saw their administrations collapse in disgrace and failure, and one, the inept Mori Yoshirō, saw his job approval rating among the Japanese public plunge to a miserable 8%, possibly the lowest popularity ever commanded by the leader of a major industrial democracy. Even Japan's most effective prime minister of the past 20 years, the charismatic Koizumi Jun'ichirō, could only deliver a fraction of his grand promises and ambitious plans when it came to reform of the Japanese political and economic status quo.

Some of the distinctive structural features of the Japanese economic system, which were well designed to deliver high growth and did so admirably from the 1950s to the 1980s, proved inflexible, confining, and burdensome in a time of economic stagnation. Thus "permanent" employment, which kept workers with one firm throughout their careers, and the seniority system, which valued persistence rather than merit as the basis for the determination of wages and promotions, made it difficult for companies to adjust efficiently to declining demand. Meanwhile, the historically cozy relationship between banks and sister firms in Japan's large *keiretsu* business groups meant that loans continued to be provided to affiliated corporations, even if they were not viable or even close to solvent, giving rise to a plethora of uncompetitive, unprofitable, but almost indestructible "zombie" companies. And the longstanding biases of Japanese corporate culture kept women from contributing to the workforce at their full potential, even at a time when creativity and fresh perspectives were in the greatest need.

The Japanese people also bear some culpability for the problems of the Lost Decade. In many ways, they behaved rationally in a situation of financial and economic crisis. Many Japanese, for example, withdrew funds from the struggling commercial banks (thus exacerbating those institutions' problems as deposits fell), and instead either put their money under their mattresses or into government financial institutions (like the gigantic postal savings system). One thing that the Japanese people resolutely did not do, but which might have contributed substantially to growth, was to spend money private sector consumption; in other words, they did not rise up to drive recovery. As in Mandeville's (1924) *Fable of the Bees*, the private virtue of thrift proved deleterious to the general population. The other thing that the Japanese public did not do, even in the darkest days of the Lost Decade, was to stand up assertively for structural change. Over the past 25 years, the Japanese people have been impassive in the face of economic stagnation and patient, resilient, and resigned in the face of lackluster political leadership, falling standards of living, increasing inequality, and growing uncertainty. Many people have simply withdrawn from the democratic process, as voting data suggest in Figure 8.

Figure 8: Japanese Voter Turn-out from 1946-2000



Data source: International Institute for Democracy and Electoral Assistance (International IDEA) (2014)

Many of those who are still engaged purport a yearning for reform yet seem to have little stomach for actual sacrifice. Perhaps this is the fault of politicians who have failed to articulate a clear vision, of a media that is often a poor defender of the public interest, and of a history of extreme administrative privilege and limited opportunity for democratic expression. One might also argue that the Japanese public has gotten the political leadership and the national economic policy which it deserves.

Today, a full 25 years after the collapse of the bubble economy, Japan continues to tread water economically, with moments of optimism only briefly punctuating a numbing and now all-too-familiar narrative of pallid growth, corporate decline, and ineffective national leadership. The triple disasters of March 11, 2011 strained an already fragile Japanese economy. With destruction totaling a sobering $360 million, the Tōhoku earthquake, tsunami, and nuclear crisis constituted the world's costliest natural disaster ever. In the short term, supply chains and communications networks were disrupted but soon put right; over the longer haul, the impact of the shutdown of Japan's nuclear reactors—on the supply of electricity nationwide and on Japan's trade balance, which turned suddenly negative due to the need for massive new oil and natural gas imports—has proven far more worrisome. And while the government's huge expenditures for the clean-up and reconstruction efforts accelerated the growth of Japan's national debt, they also brought a small silver lining, providing fiscal stimulus and forestalling deflationary pressures, at least for the time being.

The 3.11 disasters shook the already unstable political landscape and brought to power a new leader promising reform and decisive action on Japan's economic ills. Prime

Minister Abe Shinzō, carried to office in a landslide election in December 2012 and launched an aggressive economic policy designed to deliver a sharp, multi-faceted shock to Japan's struggling economy that would jolt it back to positive growth. "Abenomics" aimed to reflate the economy rapidly through massive monetary and fiscal stimulus (with negative bank interest rates, aggressive monetary easing by the Bank of Japan, and huge bond purchases by the central bank to underwrite expanded government spending on post-3.11 reconstruction). All this liquidity had the effect, at least in the short term, of spurring consumption and the economy in general as well as weakening the yen, which stimulated Japanese industry and greatly improved Japan's balance of trade. Inflation briefly flared and was hailed by Abe as a sign of budding recovery. But after a year of encouraging results, Abe's policies seemed to stall and positive trends in industrial output, employment, GDP growth, and stock prices slumped to pre-Abenomics mediocrity. A substantial hike in the national sales tax, enacted in spring 2014 to address Tokyo's persistent budget deficits, was seen by many commentators as the final straw for this latest (and perhaps most promising) attempt to shock the Japanese economy back to life.

Conclusion

As the global economy continues to struggle to regain momentum after the financial crisis of 2008, an appreciation of the lessons of Japan's quarter-century-long and seemingly endless Lost Decade seems more timely and important than ever. Regrettably, the Japanese case does not offer comforting reassurance or easy solutions for the challenges confronting all mature industrial economies today. If anything, the Japanese experience of bubble, bust, and stagnation just serves to confirm some fundamental truths that are as universal as they are commonsensical. Greed is part of human nature. Hindsight is 20/20. The optimal balance of free-market and public intervention is an elusive and ever-changing objective for regulators and market participants. Quick fixes seldom work. Drastic measures are often politically unappealing and yield unwelcome social disruption. And, sobering though it may be, not all stories—even ones that start as optimistically as that of Japan's postwar economy—have happy endings.

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