JAPAN'S TWO LOST DECADES: LESSONS FOR TODAY'S EURO CRISIS?

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1. Introduction

Japan experienced an economic boom in the middle of the 1980s. Commercial land prices in the Tokyo area increased by 57% in 1987, while those in the Osaka area rose by 36%, 36%, and 40% in 1988, 1989, and 1990, respectively. The Nikkei index increased from 12,565 yen in 1985 to 38,915 yen in December 1989. These increases led to capital gains from 1987–89 of 1,343 trillion yen, more than three times the Japanese GDP in 1989.

The boom ended in 1990 and 1991, and the Japanese economy has stagnated for the last twenty years. GDP increased slightly after the collapse but stagnated once again with the onset of the Asian financial crisis in 1997. Today, due to the Lehman Brothers shock in 2008, the GDP is almost as low as it was in 1991 (Fig. 3-1).

Economists have thoroughly studied the lost decades of the 1990s and 2000s.[1] The main issues are the following:

A) Why Japan has experienced such a long recession.
B) What remedies Japan should utilise to overcome the crisis:
    1) from the demand side: fiscal and/or monetary policies, and

[1] A number of books and articles have been published investigating why Japan experienced such a long recession. Okita (2010) discusses the Japanese post-war economy. Miyazaki (1992) is a memorable book on causes and impacts of the bubble. Chapter 19 of Hashimoto (2011) gives a very concise overview of the recession. Ogawa (2009), Kataoka (2010) and Otaki (2011) looked back the history of lost two decades. Itoh et al. (2005) and Iwata and Miyagawa (2003) collected discussions from both supply and demand sides. Todou (2011), Ono (2012) and many others discuss how to overcome the long recession from either the supply or demand side.

2) from the supply side: how to raise productivity through structural reform.

C) The effects of the lost decades:
1) on the Japanese economy,
2) on the ageing society, etc.

In this paper, we will summarise these discussions and attempt to draw lessons for today's European economy.

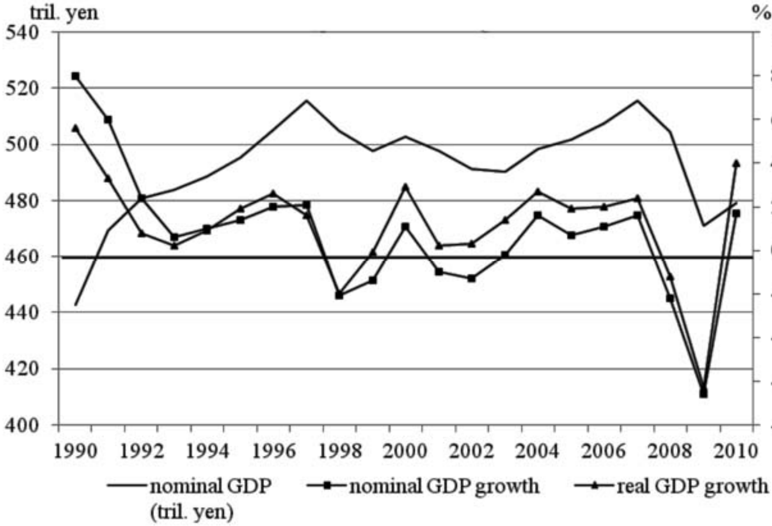

Fig. 3-1 GDP and its growth rate
Source: Cabinet Office (2011, 343)

2. After the feast

In 1991, the Japanese boom ended and the lost decades began. In the beginning, there were two serious problems: (1) an unused production capacity problem and (2) a balance sheet problem. During the bubble, Japanese companies expanded their production capacities on the assumption that the economic boom would never end. For example, the number of cars produced increased from 8.0 million in 1985 to 13.2 million in 1991, only to decrease to 10.8 million in 1995 (Statistics Bureau 2011a). With the bust, these capacities became excessive.

When the bubble burst in 1991, the capacity utilising rate of the manufacturing industry as a whole dropped from a rate of 100–110 to 90–100 (Fig. 3-2). The capacity utilisation rate of the automobile industry decreased drastically to a rate of 70–80; the steel industry soon fell to a similar level.

As Japanese companies reduced investment, productivity stagnated and, in the second half of the 1990s, unemployment began to increase.

The more serious problem was the balance sheet problem. With Japanese companies believing that land prices would remain high, they increased borrowing with land as collateral. When land prices began to fall, the land standard system – borrowing with land used as collateral → new production capacities → sales increase → profit increase → price increase → land price (collateral) hikes → borrowing – also collapsed, and non-performing loans abounded. The non-performing loan problem was most serious in the real estate, construction, and wholesale & retail sectors, as these three sectors very prominently expanded their capacities on the basis of the land standard system (Fig. 3-3).

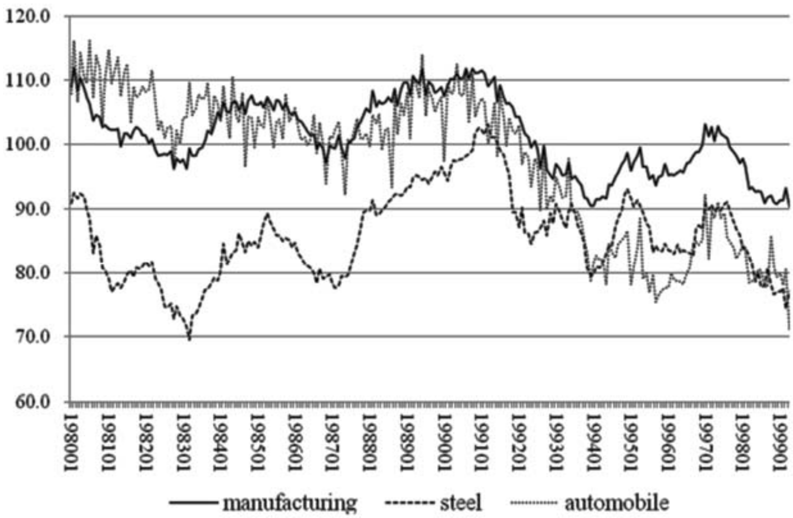

Fig. 3-2 Capacity utilisation rates
Source: Author's compilation based on the data of Ministry of Economy, Trade and Industry (2011)

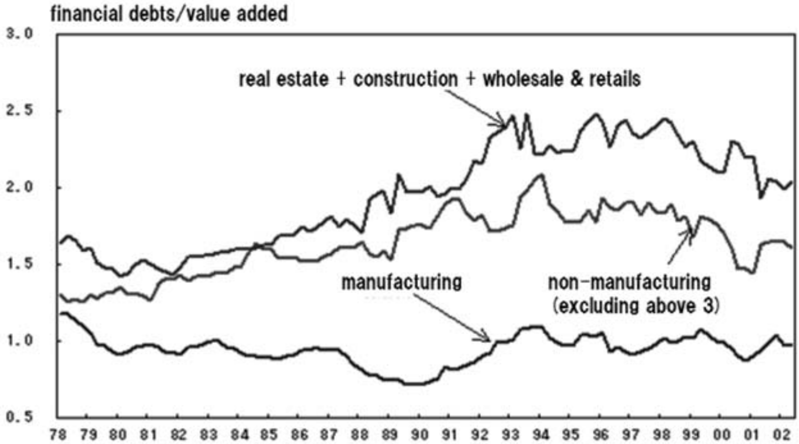

Fig. 3-3 Non-performing loan problems
Source: Cabinet Office (2002, 34)

Though Japanese banks faced increasing numbers of non-performing loans within the above three sectors, they, somewhat surprisingly, continued lending to these companies. The banks, companies, and government all believed that the economy would soon recover, but this was not to be. Some companies within these three sectors went bankrupt, and the non-performing loan problem was transferred onto the banking sector.

Figure 3-4 reveals that the non-performing loan problem first impacted the banking sector in 1995, four years after the bubble burst, and that it took nearly seven years to resolve. There are several reasons why this took so long. First, the companies, banks, and government all underestimated the seriousness of the recession. Second, in the beginning, the definition of non-performing loan was excessively narrowly defined by the government. Third, a debate on who was responsible for the costs of the non-performing loans took place. In particular, the general public could not consent to the idea that the non-financial sectors or the financial companies with non-performing loans would be bailed out by tax-payer money. Finally, the Ministry of Finance tried to sustain the convoy system (*Goso Sendan Houshiki*) by adjusting the banking regulations so that not even the worst-off banks would fall into bankruptcy. For example, each bank offered the same interest rate on deposits.

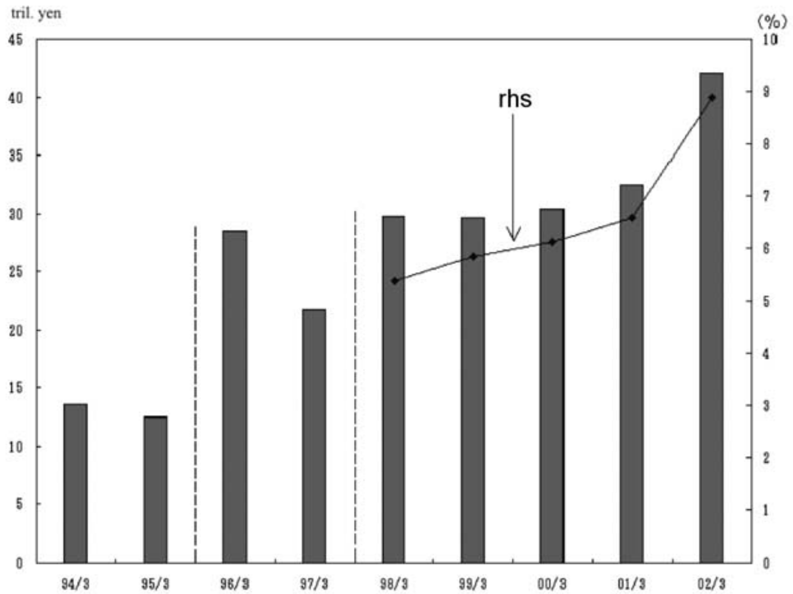

Fig. 3-4 Banking sector’s non-performing loans
Source: Cabinet Office (2002, 47)

The situation dramatically changed in November 1997 when two large financial institutions went bankrupt. First, Hokkaido-Takushoku Bank, one of the largest Japanese banks, failed due to a resort development project in Hokkaido and closed its doors on 15 November. Then, Yamaichi Security, the second largest security company after Nomura, declared bankruptcy on 24 November due to enormous off-the-book liabilities.

Insolvencies occurred before these two large financial institutions went bankrupt. One example is a bankruptcy of Hyogo Bank several months after the Great Awaji Hanshin Earthquake, which hit Kobe, where the headquarters of the bank were located, in January 1995. The bankruptcies of Hokkaido-Takushoku Bank and Yamaichi Security signalled that the Ministry of Finance could no longer sustain the convoy system, resulting in the other large financial institutions substantially increasing the pace of their financial consolidations. This led to the establishment of megafinancial systems in Japan: four financial groups[2] and the independent Nomura Security.

Discussions on whether the government should inject capital into the large banks continued. On the one hand, it was difficult to convince the general public that financial institutions should be bailed out by tax-payer money. On the other hand, the large banks refused to accept the capital injections because they were afraid of being nationalised.

In October 2002, the Koizumi Cabinet settled on the “Program for Financial Revival”, which dictated that the Financial Services Agency normalise the non-performing loans (NPLs) problem by reducing major banks’ NPL ratio to approximately one-half (Financial Service Agency 2002).

In June 2003, the government injected two trillion yen into Resona Bank, whose financial condition was the worst among the mega-banks. Other mega-banks augmented their capital by issuing proffered stocks and allocating shares to third parties in order to avoid nationalisation.[3] As shown in Figure 3-5, the large banks’ non-performing loans began to decrease from a peak of 25 trillion yen in the beginning of 2002. While 56 banks went bankrupt in 2001, only one bank has done so since 2002.

It took more than ten years after the collapse of the bubble to settle the non-performing loan problem. It is not difficult to imagine such an enduring experience significantly changing the behaviour of Japanese companies and households.

A) Banking sector:

The first consequence of the non-performing loan problem is that Japanese banks gradually became reluctant to extend credit to businesses, even those with healthy financial outlooks, to preserve the capital adequacy ratios defined by the Bank of International Settlement (BIS). The role of Japanese banks as funding centres diminished. The second consequence is that their role as main banks also decreased. The symbolic event was the merger of Sumitomo Bank, the main bank of the Sumitomo group, and Sakura Bank, the main bank of the Mitsui group, in 2001. The decrease of roles of main banks was not limited to large banks. As small banks’ financial positions became more vulnerable and they became less willing to extend credit, their roles as main banks to small and medium enterprises (SMEs) also diminished.

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[2] Mitsubishi Tokyo UFJ Financial Group, the Sumitomo Mitsui Financial Group, Mizuho Financial Group, and the Resona Group.

[3] Nishikawa (2011) described how the author, then governor of Sumitomo Mitsui Financial Group, overcame the non-performing loan problems.

B) Non-banking sectors:

Most companies within the non-banking sectors also made serious efforts to survive the non-performing loan problems. The easiest way was to reduce costs by curtailing investments and employment. However, this led to the fallacy of composition problem. The fact that investment demands and household incomes have not increased is one of the reasons why Japanese GDP has stagnated for the last twenty years. However, the more serious problem was that curtailing investments led to competitiveness losses within Japan's manufacturing industries. Whether the Japanese TFP (total factor productivities) has plateaued is one of the biggest discussions on the lost decades (Hayashi and Prescott 2002). Discussions on supply-side options ensued.

C) Households:

As mentioned in the previous paragraph, Japanese companies tried to curtail labour costs, and household incomes have stagnated for the last two decades. Additionally, deflation and household thriftiness led to decreases in consumption.

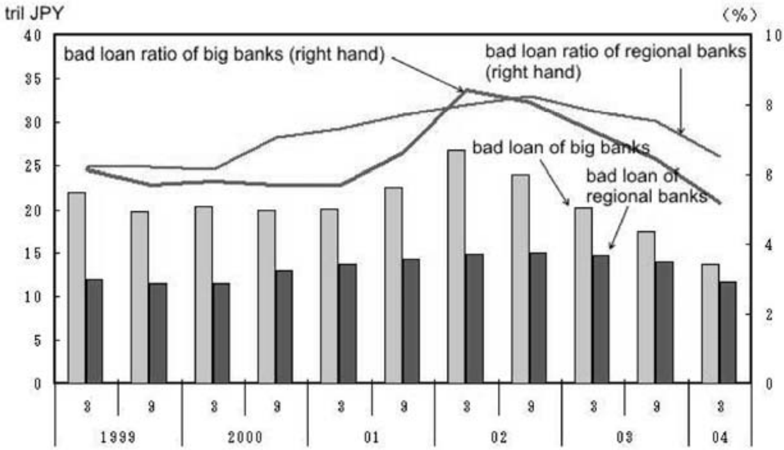

Fig. 3-5 Resolution of non-performing loans
Source: Cabinet Office (2004, 85)

3. Stimuli to recover

3.1 Timid attitude of the government in the 1990s

The Japanese government did not sit idly by as the economy faltered. At first, the government tried to support the economy from the demand side through active fiscal policies to increase public investments and reduce taxes. The Bank of Japan (BoJ) also relaxed monetary policy. The government also tried to support the economy from the supply side through structural policies. These measures were not successful.

First, let us look at the fiscal policy of the 1990s (Fig. 3-6). We notice the following points. Expenditures increased during the period at approximately the same pace. The government had no choice but to continue using active fiscal policies since the economy continued to stagnate for the next ten years. Second, tax revenue had significantly fallen. The government expected that reducing tax rates would save the economy and increase tax revenue. However, the expectation was not realistic. Third, because of increasing expenditures and decreasing tax revenue, the state debt has increased. However, looking at the figure in detail, we find that the deficit government bond, which is issued for the purpose of covering the budget deficit, was not issued until 1994. This might indicate that the government did not strongly intend to stimulate the economy at that time.

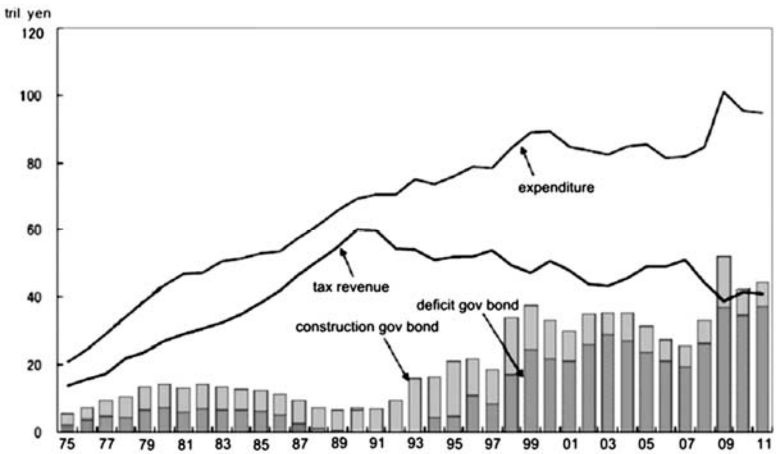

Fig. 3-6 Japanese central government budget
Source: Ministry of Finance (2011a)

Regarding the monetary policy of the 1990s, we notice the timid attitude of the Bank of Japan. After the official discount rate reached six per cent during 1990, it continued to decline. It was not until 1995, four years after the bubble burst, that it reached the bottom level (Fig. 3-7). From these facts, we may say that the BoJ might think that keeping the interest rate level high enough to hold down the land price hikes was still the priority task even after the bubble burst, that the BoJ also thought that the Japanese economy would recover soon, and that capital losses could be recovered in the near future.

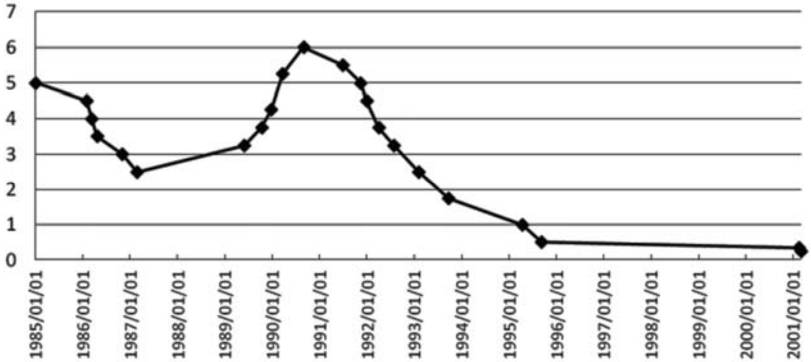

Fig. 3-7 Official discount rate
Source: Bank of Japan (2011)

3.2 The government policies of the 2000s

The 2000s were years of deflation. Returning to Figure 3-1, it shows that the nominal GDP growth rates have been less than the real GDP growth rates. That means that GDP deflators and price indices were negative during the 2000s. Because the macroeconomic environment changed in the 2000s, the Japanese government also changed their policies.

Referring to the government budget (Fig. 3-6), we find that the government (i.e., the Koizumi Cabinet between April 2001 and September 2006) tried to curtail expenditures and the issuing of state bonds. This fiscal approach saw modest success with a weak but extended boom in the middle of the 2000s.

The Lehman Brothers shock frustrated this fiscal strategy. Expenditures increased to 101 trillion yen in FY2009 from the previous year’s 85 trillion yen, and state bond issuance increased by 20 trillion yen to 52 trillion yen in FY2009. The Japanese fiscal situation had reached a very dangerous point in that the value of the newly issued state bonds surpassed that of tax revenue.

Table 3-1 shows the overnight call rate target, which is today's policy interest rate. The BoJ has adopted a zero interest rate policy since 1999 (except for a short period between August 2000 and February 2001).

Table 3-1 Overnight call rate target

date	overnight rate target	remarks
2/1999	0.15%	zero interest rate policy
11/8/2000	0.25%	temporary lift
28/2/2001	0.15%	reintroduction
14/7/2006	0.25%	re-lift
21/2/2007	0.50%	
31/10/2008	0.30%	
19/12/2008	0.10%	
5/10/2010	0.0 – 0.1%	

Source: Authors own construction by The Bank of Japan

When the IT bubble burst in 2001, the BoJ had no room to lower the interest rate. Instead, the BoJ turned to an unconventional quantitative easing policy to broaden the monetary base by buying financial assets and injecting a pre-determined quantity of money into the economy. This increased the excess reserves of the banks. However, comparing how the monetary bases in the US, Japan, UK, Euro-area and China were broadened (Fig. 3-8), we note that the BoJ was very timid in broadening the monetary base during the 2000s. As a result of the BoJ failing to broaden the monetary base to an extent similar to the US or the ECB, some economists demanded that the BoJ introduce the inflation target policy[4] and more decisively broaden the monetary base.[5]

Let us summarise the reasons why the monetary policies were ineffective for the last two decades. First, the priority of the monetary policy remained controlling high land prices even after the burst of the bubble. Second, a de facto zero interest rate policy began at the end of the

[4] At the Monetary Policy Meeting on 14 February, 2012, The BoJ for the first time officially mentioned the inflation target, saying that The Bank judges "the price stability goal in the medium to long term" to be within a positive range of 2% or lower in terms of the year-on-year rate of change in the CPI and, more specifically, sets a goal at 1% for the time being.

[5] Moriyama (2011) is an example.

1990s but was only modest in effect. Third, a de jure zero interest policy was introduced in 1999 but was lifted while the recovery remained weak and the IT bubble had not yet burst. Fourth, quantitative easing was introduced, but the monetary base remained insufficiently large. In sum, the BoJ failed to introduce the bold policies necessary to overcome the stagnant economy of the last twenty years.

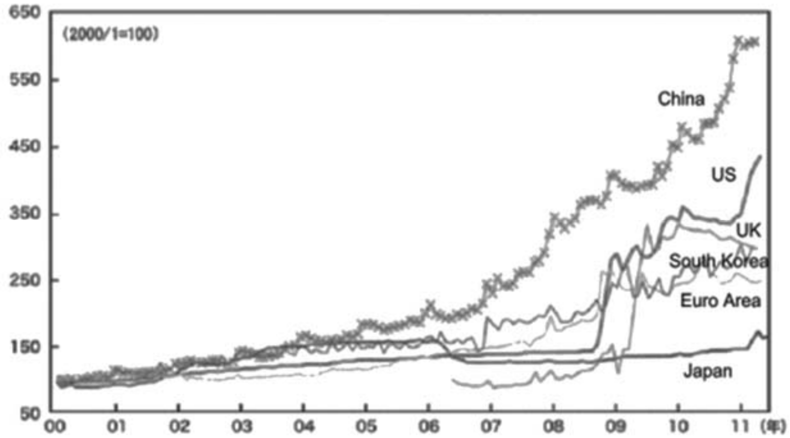

Fig. 3-8 Monetary base balance
Source: Daiwa Institute of Research (2011)

4. Structural reforms

In the previous sections, we have discussed how to increase demand via fiscal and monetary policy. However, policies from the supply side were also considered. These policies always emphasise the importance of breaking away from the Japanese economic system, which was admired with *Japan as Number One* in the 1980s (Vogel 1979).

A) Public structural reforms:

Public structural reforms were mainly driven by the Koizumi Cabinet. Prime Minister Koizumi emphasised it with the phrase “No Reform, No Growth.” The three pillars of the reform were:

1. from public to private
   - privatisation of the postal and highway systems,
   - marketisation test,

- deregulation of the labour market,
- integration and abolition of public entities,[6]
- promotion of special zones.

2. from centre to region
   - abolition and curtailment of state subsidies,
   - transfer of tax sources,
   - revision of local allocation tax grants.
3. other reforms
   - promotion of Free Trade Agreements and Economic Partnership Agreements,
   - medical system reform,
   - off-budget system reform.

The most debated reform was privatisation of the postal system. When the Postal Service Privatization Act was rejected by the Upper House in August 2005, Prime Minister Koizumi dissolved the Lower House and called a general election. After Koizumi won the election, the law was approved. The Japan Post System was divided into the Japan Post Service, Japan Post Bank, Japan Post Insurance, and Japan Post Network.[7]

Additionally, labour market reform increased the flexibility of the work force. The share of permanent workers decreased from approximately 75% in 2000 to approximately 65% in 2009.[8]

B) Private structural reforms:

Regarding private structural reform, breaking away from the Japanese economic system was the key idea. Some examples follow.

1. dismantling *keiretsu* (grouping)

Under the Japanese economic system, the sub-contracting system was widely used. Assembly (parent) companies purchased parts of the products from sub-contractors (child companies) under the same *keiretsu*. The *keiretsu* system began to be dismantled in 1999 when Carlos Ghosn became president of Nissan.

2. dismantling main banks

Mutual/cross holding of stocks among the group companies, with banks being at the top of the cross holding system, was very common. For example, Mitsubishi/Sumitomo/Mitsui Banks were the main banks of the

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[6] National universities were transformed to national university corporations in April 2004.

[7] See the organization chart: http://www.japanpost.jp/en/group/map/.

[8] *Annual Report on Japanese Economy and Public Finance, FY2009.*

Mitsubishi/Sumitomo/Mitsui Groups. When these banks began to address their non-performing loan problems, they could not afford to maintain the main bank system.

3. corporate governance reform

Based on the life-long employment system in Japan, most presidents of large companies designated their successors, and outsider influence was very limited. In 2003, the Commercial Law was revised and some Japanese corporations introduced the committee system.[9]

5. The consequences of the lost decades

In the previous sections, we showed how the Japanese government and companies struggled to overcome the non-performing loan problem and the stagnant economy. The main consequences of the lost decades were the following.

A) Competitiveness loss

Has Japan regained its competitiveness? Japan’s IMD World Competitiveness ranking is shown in Figure 3-9. Japan fell from its highest competitiveness ranking to today’s ranking of just 26th. The fact that today’s GDP is approximately the same as that of 1991 symbolises Japan’s stalled competitiveness.

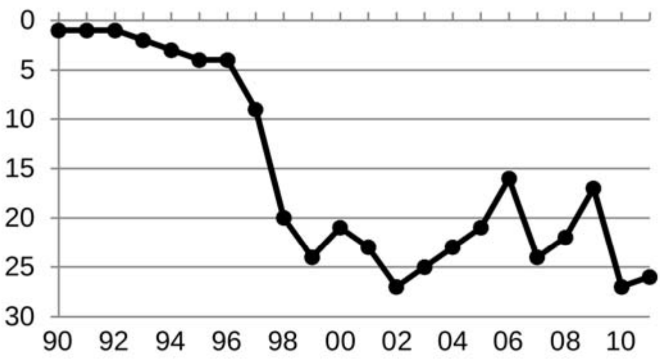

Fig. 3-9 Japanese competitiveness
Source: Kogures.com (2011)

[9] http://www.sony.net/SonyInfo/News/Press_Archive/200301/03-004E/

B) State debt

One of the greatest consequences is the state debt (Fig. 3-10). Because of increasing fiscal expenditures and the revenue gap since the end of the bubble, state debt has been increasing. Its accumulation accelerated particularly after the Lehman Brothers shock of 2008. The state debt at the end of Fiscal Year 2011 (March 2012) was 667 trillion yen, 141% of GDP. It should be noted that this debt is the responsibility of the central government alone. Adding the local government debts, the figure increases to 894 trillion yen, 189% of GDP (Ministry of Finance 2011a). The general government debt, which includes the social security fund deficit, etc., is 1,024 trillion yen, almost 200% of GDP (Ministry of Finance 2011a).

These figures are the worst among advanced economies, even considering the Greek figures. However, the possibility of fiscal insolvency in the short term is limited since almost all of the state debt is held by the Japanese people.

The risk of fiscal insolvency in the long term, however, is high. As the Japanese society ages at an increasing rate, expenditures for social security will increase. At the same time, the Japanese saving ratio will decrease, leading to a current account deficit. These trends may force the Japanese credit rating to be lowered, increasing interest rates and making it more difficult to redeem government bonds.

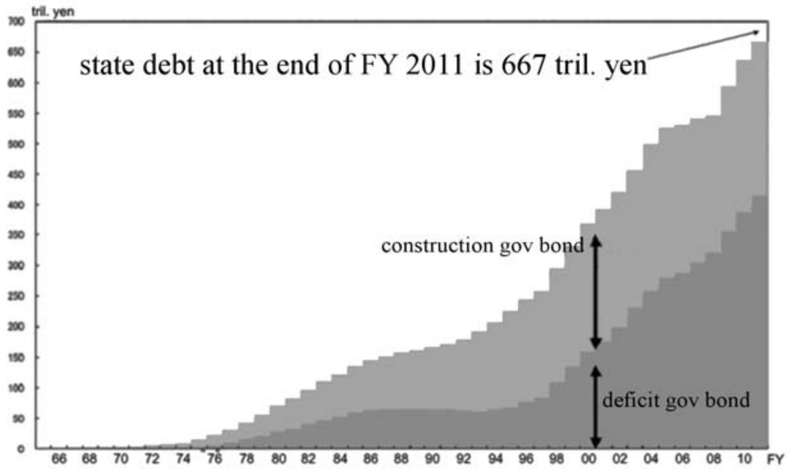

Fig. 3-10 Central government debts
Source: Ministry of Finance (2011b)

C) Public structural reforms

As mentioned earlier, the postal and highway systems, as well as other public corporation systems, were reformed in the 2000s. Before this, there were reforms of the national railway, telegraph and telephone, and tobacco and salt public corporations during the 1980s (today's Japan Railway (JR) networks, NTT groups (Nippon Telegraph and Telephone Corporation), and Japan Tobacco).

Except for some of the JR groups (JRs Hokkaido, Shikoku, Kyushu and Freight), which have never turned a profit due to their challenging geographical situations, shares of the formerly public corporations were sold to the public. They were, genuinely speaking, privatised.

Shares of the Japan Post and the Japan Highway groups, however, remain in the hands of the government. They were corporatized, but their privatisation, i.e. concrete tender programs, have not yet been finalised. Furthermore, due to the ousting of the Liberal Democratic Party, which had ruled Japanese politics for more than fifty years, in 2009, the privatisation program of the Japan Post group is now being reconsidered.

D) Private structural reforms

Regarding private company reforms, we have seen that corporate governance and other reforms were initiated in the 2000s, but they have not yet borne fruit. For example, Sony is thought to have lost its innovative edge (Tateishi 2011 and Tsujino 2011), has posted losses every year since FY2008, and has announced the dissolution of its joint venture with Samsung to produce LCD panels. Furthermore, window-dressing settlements of Olympus and unjust financing to the former chairperson by Daio Paper have revealed that corporate social responsibility has not penetrated sufficiently into Japanese corporations.

6. Conclusions

We summarise what we have discussed as follows.

In the 1990s:

- The Japanese government and private sector had optimistic views of the recession after the bubble burst in 1991. They thought the recession would come to an end soon and that the virtuous cycle of the Japanese economic system, including the land standard system, would work well again. This belief caused a delay in acknowledging the seriousness of the recession.
- The stimulus fiscal package was too little, too late.

- The monetary authority was afraid of the land price hikes and their monetary policies were timid.
- The collapse of the bubble caused the non-performing loan problems in the non-manufacturing three sectors and then in the banking sector. It was not until 2002 that the non-performing loan problem in the banking sector was resolved.
- GDP increased a little even after the collapse of the bubble, but stopped growing in 1997 when the Asian financial crisis took place.

In the 2000s:

- The non-performing loan problems were resolved in 2002 after the Koizumi Cabinet settled on the "Program for Financial Revival."
- In the process of resolving the non-performing loan problems, Japanese banks became reluctant to lend to companies, especially small and medium-sized enterprises.
- Even during the weak but long boom of the 2000s, Japan's state debt continued to increase. After the IT bubble burst in 2001 and the Lehman Brothers shock in 2008, extremely aggressive fiscal policies made the state debt situation much worse. Today, the state debt is valued at 200% of GDP.
- The state debt is a serious concern for the ageing society of Japan.
- The Japanese government tried to implement structural policies to raise productivity and increase the effectiveness of the economy. However, the government policies were not bold enough to be successful.
- Japanese companies tried to reform themselves. However, the reforms were insufficient and the Japanese economy has not recovered its competitiveness of the 1980s.

The EU economy has been seriously damaged by the Lehman Brothers shock and the euro crisis. Most EU member countries have accumulated large sovereign and private debts since 2008 (although the Japanese debt remains higher).

The EU economy is now searching for an exit from their unhealthy situation. The European Stability Mechanism (ESM), which will come into force in September 2012, is expected to reform the functioning of the euro zone. It is also expected to accelerate the fiscal consolidation process and to facilitate harmonisation of the fiscal systems among the member countries. The EU also adopted the "Europe 2020" strategy to increase its competitiveness.

However, the Japanese experience shows that these efforts will not bear fruit if the governments, the ECB, and the companies do not take prompt and decisive measures. If they do not, they may also experience at least two lost decades.

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