HÁSKÓLI ÍSLANDS

Hugvísindasvið

The Japanese Economy

A Return to Growth

Ritgerð til B.A.-prófs í Japönsku: Máli og Menningu

Hinrik Örn Hinriksson

Maí 2012

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Abstract

The Japanese economy has gone through drastic changes in the past sixty years. After the Second Sino-Japanese War, when the Japanese nation was defeated by the Americans and the nation was occupied by the American military many changes took place in the Japanese economy; it was opened up to foreign investors, so foreign FDI was now allowed in the country with minimal interference by the government. The currency was revalued making merchandise from Japan less practical, as it got too expensive for other countries. The Japanese economy flourished during the 1980s and an economic bubble was formed; by the late 1980s housing in Japan was the most expensive in the world and the Japanese stock market was booming. Then in 1991 when the economic bubble finally burst with drastic consequences, many companies, banks and other institutions went broke, stock and land prices plummeted in value, and millions of people lost their jobs. The government implemented rescue packages to try and salvage the economy but with little success.
Efforts have been made for two decades to get Japan out of the economic slump, and get the economy running as it used to with a double digit economic growth rate, but the fact is it’s only around 1 percent after the bursting of the bubble. Ever since the government and banks have been struggling, to try to get the economy back on track. Changing policies and rising fiscal deficits characterize the economy today, moreover, LDP the leading political party for over fifty years has lost its power over the Diet and DPJ have the current majority, getting an unprecedented majority of representatives. Cutting ties with the keiretsu affiliation and taking up a more western type of commerce, the Japanese are saving money and changing the set up of the companies, making them more efficient and more competitive. The economic outlook of the country continues to spark debate, the Japanese are hard workers and with the correct measures they ought to be able to overcome this rough patch they are going through.

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1. Introduction

The downfall of the Japanese real estate market and asset price bubble in the early 1990's has been the focus of economists, looking into economic developments in the world, filling books, articles and magazines now for more than two decades. Why did the Japanese government not spot what was happening to the economy at an earlier stage and why was the government so slow to act when the imminent threat became obvious, failing to adopt measures to prevent the falling stock prices and the imminent downfall of the land value in time? In my dissertation I want to try to find out if the Japanese model of reconstructing the economy has worked, what has gone well and what should have been looked at more carefully before being put into action. I will go over what led to the crisis in Japan and explain what the government is doing to recover looking into what the Japanese government did correctly and what is to be avoided. Moreover I want to know what led to the failure of the banks, how they were functioning at the time of the high growth period and how they did while the recession passed over. The Japanese economy has been accumulating debt since the downfall of the economy in the early 1990's, the big question is can they break free from their debts?

2.1 Pre-crisis situation

The Japanese pre-bubble period can be looked at from many different angles, but one thing is certain, the country went through decades of high speed growth with double digit economic growth and quickly caught up with the western economies, however, like all economies Japan went through some rough patches, two oil crisis' and a revaluing of their currency that got stronger very rapidly over a short period of time. The Japanese economy is very valuable to the world economy. Japan is one of the biggest foreign direct investors (FDI) in the world, and many other nations provide the Japanese companies with commodities and are therefore deeply invested in the Japanese economy. If it does badly, less demand will be on Japan's behalf for what the other countries are providing it, so keeping the Japanese economy stable is very important to millions of people all over the world.

2.1.1 Currency

The Japanese currency is called Yen or ¥, it is one of the leading currencies in the world and is in fact one of the strongest currencies globally, that is to say, one of the most reliable currencies fluctuations wise. This should come as no surprise as the Japanese nation propel the third largest economy in the world, after the United States and China. However the Japanese economy was the second largest, right up until 2010 when China passed them.

When the yen (¥) was floated on February 14th 1973, it only took a short time for the rate of the yen to advance to double of what it began as, in October 1978. The yen had already gone up quite a bit and the dollar stood at roughly 170 yen to one dollar in October 1978, a peak that was not expected at the time. In 1977 the United States Secretary of the Treasury, Michael Blumenthal indicated that the yen was rated too low and therefore facilitated exports. He said the yen ought to be valued higher, shortly after this announcement the yen took off in the exchange markets and sharply rose over the next couple of years, especially in 1977-78. The result was that many exporting companies were unable to break even and many of them did not survive the crisis. In December 1979 the Ministry of Finance (MOF) had lifted many of its restrictions concerning inflow of funds from overseas, because prior to that, all foreign exchange transactions that had not specifically been permitted were banned. Now however, all exchange transactions have been in principle permitted, which has helped Japanese companies a great deal since they no longer need to seek funds exclusively in Japan, but can now look for them wherever they desire. The government of the United States of America and Japan came to an agreement called the Plaza Accord on September 22nd 1985 which was aimed at revaluing the Japanese yen and the German mark, taking the yen from about ¥240 to 1US$ and appreciating it so it would stand around ¥200-210 to 1US$ this was an agreement between countries involved, and that set the tone for what was to come. The Japanese ¥ was quickly valued and by the end of 1986 it had reached ¥150 to 1 US$. In February 1987 in order to to deal with the sudden strengthening of the Japanese ¥ the Louvre Accord was signed, however unfortunately it did not help and the currency kept on rising and had reached ¥120 to 1 US$ in the beginning of 1988. The Japanese currency appreciate has reached more than 300 percent against the American dollar, since it was floated (Takafusa, 1994).

2.1.2 Political situation

Tanaka Kakuei was the first Prime Minister after the WWII that did not have a college degree, and he was also the youngest Prime Minister who envisioned a drastic reform of the Japanese economy. His vision aimed at increasing public spending after 1971 and also to address numerous problems accumulated during the high growth period. Moreover he wanted to build smaller cities in rural areas to improve the livelihood of the people in the country. However the plan did not work as well as he had hoped. The first oil shock triggered hyperinflation and land policy was not good enough which in turn made the banks gain more from lending money to companies in the construction sector because of rising land values, the rise of land price was inevitable (Gao, 2001).

Kazuo Ueda argues that the Japanese post-war financial system can be traced back to the inter-war and Second World War. He says the way to achieve a non-economic objective of managing a war, a mechanism for the planned and controlled allocation of recourses is needed, rather than a decentralized allocation mechanism. So long-term capital was brought about in two stages; through city banks and long-term credit banks, and fortified by government financial institutions. And as the whole system was subsidized by government credit, the cost of capital was reduced. This was exactly the sort of arrangement that had been learned from the old wartime system. Secondly Ueda mentions the financial regulations that have been dismantled and those still in force, he says the ones still in force are there because of government intervention that may be necessary, even in advanced countries, to maintain the stability of the financial system (Okazaki, Okuno-Fujiwara, 2002).

2.2 Bubble period

2.2.1 Japan's banks

Japan's banks are one of the main reasons for the formation of the bubble and for its burst as well. Many theories have been put forward to as why the banks were so compliant to the government of the country and why they did not refuse some of the deals the government pushed at them with great pressure. Moreover it raises questions about the board of directors controlling the banks.

The bulk of Japan's financial system was formed between World War I and World War II, in 1927 the Banking Act, or the Ginkō Hō was presented and in January 1928 it was put into force. Some of this legislation, such as the Banking Act (revised in the 1980's) has been revised. However much of this inter-war legislations is still in act today, and one can only wonder if it still enforces what it was meant to do at the time of its enactment, For example the Banking Act was meant to channel money either directly or indirectly money into the munitions industry and to help stabilize the financial system of the country, however today this cannot be the main goal of the governmet, as the army is not functioning the same way as it did back then and that the world is not even at war right now (Okazaki and Okuno-Fujiwara, 2002).

“The Industrial Bank of Japan (IBJ) was selected by the MOF in 1944 to be the leading lender to the munitions industry. The IBJ funded a 146 cases out of 831, making it 76 percent out of IBJ’s outstanding loans”. (Okazaki and Okuno-Fujiwara, 2002, p. 46).

The so-called convoy system prevented banks from failing and assured that they would turn a profit. The Ministry of Finance (MOF) engineered a takeover by a bigger stronger bank, if a weaker bank showed signs of going under. They organized loans from the government and private financial institutions to bail out the struggling banks. Since there was a no failing guarantee the creditors and borrowers were more or less in the clear, because if the bank would in fact go under there was a big chance it would threaten the solvency of the lender (Alexander, 2002).

> Due to excess savings syndrome, every year trillions of yen of un-needed deposits flooded into the banks [...] in order to meet interest and dividend payments. Figuring more was better, the banks in Japan expanded their commercial loans from 73 percent to 97 percent of GDP in the five short years from 1987-1992.
>
> (Katz, 2003, p. 91-92).

2.2.2 The real estate bubble

The real estate market in Japan in the late 1980’s was unprecedented, land and property prices were so high that people lived in confined apartments. It was estimated that each person lived on 7 tatami mats (around 14 square meters), luckily for the Japanese citizens the number had risen to 10 tatamis (20 square meters) by 1988. It was said that the property value of the Imperial Palace in Tokyo was higher than that of the entire state of California (USA). Between 1986-1987 Tokyo land prices more than tripled in price, making it very sought after to obtain these properties. A little later, or by the end of the 1980’s the land prices in other regions started going up steeply as well, first in the Osaka-region and then in Nagoya. It was easy for major corporations to obtain large sums of money with minimum effort and little risk. Many people also founded special holding groups with the sole goal of obtaining properties and gaining money from transactions related to real estates (Takafusa, 1994).

In the 1970's the banks funded over 40% of the largest firms in Japan. However, by the late 1980's the large corporations started to fund themselves by issuing stocks and bonds. This meant that the banks ended up only funding around 6% of that market, turning to medium and small firms as well as individual borrowers. This transition was prompted by the deregulation and liberalization of capital markets (Yoshikawa, 2001).

The Japanese people only inhabit 15 percent of the land, due to their mountainous landscape, which means that building land tends to be very expensive and in great demand. Over the past four decades there has been such a rapid increase in price that no other country comes close to Japan regarding land prices, which is why it can seem easy for a bubble to form and expand. In 1990 the urban land was estimated at 4.8 times the GDP and 57 percent of the national wealth. One of the main problems with the rising land prices was the fluctuation in price, which contributed to the instability of the Japanese macroeconomics (Sato, 1995). "Thus, the formation of land prices is a critical factor which affects the performance of Japan's macroeconomy."(Sato, 1995, p. 153).

One of the main reasons for the sudden jolt in the real estate prices was the expected returns. The annual rate of commercial land soared in 1986, increasing by 37.2%, while the industrial land was still rising by just 7.8%. Thus, there were significant differences in the rate of appreciation among different types of land (Yoshikawa, 2001).

Companies and investors bought and sold stocks and bonds, which investors bought with low interest rates in the hopes of realizing capital gains (Kano, Noguchi, Saito and Shimada, 1993). "In the three years from 1987 to1989, corporations raised over ¥58 trillion in this manner." (Kano, Noguchi, Saito and Shimada, 1993, p. 37).

The burst of the Japanese bubble in the start of the 1990s is said to be the biggest boom of the late twentieth century, with land prices rising by 550 percent during a period of only 10 years. Between 1981 and 1991 the land prices in Japan became so high that land was valued at 20 percent of the worlds wealth at the time. However, by 2002 the average land price had fallen by about 70 percent compared to the 1991 level (Kaizoji and Kaizoji, 2004).

3. Crisis

3.1 Stock market

> The Nikkei average of 225 issues on the Tokyo Stock Exchange practically doubled from 8800 in 1983 to 16401 in 1986 (annual averages). […] In 1989 the Nikkei average hit 38915. Stock prices were by this time more than four times the level they had been in 1983.
>
> (Kano, Noguchi, Saito and Shimada, 1993, p. 33).

"When the stock price is substantially overvalued, its dramatic decline is inevitable. No government policy can stop the decline until the price is adjusted to its fundamental value." (Fukuda and Yamada, 2011, p. 448) The dramatic price decline of the stocks produces a major problem from a political point of view, when the people start calling out for a solution before their assets vanish completely, hence the Japanese government is forced to implement expansionary policies, which was the case when the bubble burst in the early 1990s. (Fukuda and Yamada, 2011).

Discretionary policy has been refocused on in the past few years after the economic crisis all over the world. Discretionary fiscal policies have to be looked at not only from a short-term point of view with short lasting benefits, but as well the long term point of view and cost deriving from that. The Japanese way of discretionary fiscal policy under stock price targeting is believed to have resulted in a huge fiscal deficit for the country in the long run (Fukuda and Yamada, 2011).

Given what was believed at the time about the economic developments, it is understandable that the BOJ decided to loosen the monetary policy in the early 1990's, it is not given that the government knew what was about to happen to the economy. When the bubble burst the interest growth rates fell nearly continuously from 1990-1992. The BOJ is believed to have created the excess liquidity that gave rise to the bubble, when it finally burst the BOJ should have had decisive monetary easing and brought the bubble economy to normal levels, or until stock and land prices went back to what they had been before the start of the asset bubble (Hamada and Okada, 2009).

3.2 Government interference

The government in Japan seems to have used its banks to churn out loans that were not going to be paid back, when loans carrying interest rates of merely 1.0-0.5% are not being paid back, and the companies that often employ thousands of workers get debt forgiveness because of their large workforce. For example, in January 2002 Prime Minister Koizumi pressured the banks to give a retail giant called Daiei another bailout, with debt forgiveness of around 400 billion yen. His reason was simple; the company employed too many workers and therefore it could not be allowed to fail. Overall problematic bank debt, including loans that are being served on time but have shaky borrowers are commonly estimated at around a staggering ¥100 trillion, which is around 20% of GDP, with no other developed country coming close to this magnitude of a banking situation. This Zero Interest Rate Policy (ZIRP) pushed forward by the government of Japan, has had the effect on the companies that they do not need to restructure or change anything in their behavior in the financial market, they keep on functioning as if nothing has changed, and thus due to huge debt forgiveness and the ZIRP. Easy money and government initiatives have helped out many companies (usually well connected) companies to assist them with their “reorganizing” that is to get debt forgiveness and more loans. Many international companies have questioned whether it would be easier and better in the long haul to let the companies that act like zombies[1] go belly up and reorganize what is left of those companies and their personnel, this is what companies like the IMF, Standard & Poors (S&P) and other rating companies/banks are pointing out. The crisis is so bad that Moody’s (rating company) has said that the problem is so big that it exceeds the bank’s capital making it technically insolvent, and that is without taking into account debts the government does not recognize. The number of people in danger of

[1] The companies that really should have gone bankrupt when the crisis hit and in theory have gone bankrupt but are still functioning with a lifeline from the government are often called Zombie companies.

losing their jobs is colossal. David Atkinson (Goldman Sach's Tokyo office) believes that one-fifth of the entire workforce in Japan is employed by firms on the verge of bankruptcy, near bankruptcy or troubled. He claims that nearly four million people are at risk of losing their jobs, and only half of them will be able to find new ones after being laid off, and those numbers do not take into account the domino effect of what would happen if they lost their jobs, cut their spending and firms cutting their purchases of supplies etc. (Katz, 2003).

The Japanese government maintained that business conditions were good ant that the economy was gradually recovering. This claim was made in November 1996 in the *Monthly Economic Report,* as soon as January the leading indicators started to drop, making this statement questionable. Still in April 1997 the government issued yet another *Monthly Economic Report* talking about the accomplishments and improvements being made by the government in the economy. With consumption tax rate raised from 3% to 5% that very month, the government showed no signs of paying attention to the problems awaiting the government. In September of the same year there was no change of tone in the *Monthly Economic Report,* the government kept on painting a positive picture of the Japanese economy (Yoshikawa, 2001).

The Ministry of Finance has constantly pressured the government ministries to cut back on expenditures when drawing up their initial budgets in order to eliminate fiscal deficits. The country is doing so badly that the government is talking about a "fiscal reconstruction" in order to save the economy. When the hoc council Rinco was established in 1981, the main objective was to look at administrative reform, and from July 1981 through March 1983, 5 reports on the matter were issued, pointing out various flaws in the government bureaucracy. The government has with the help of the Rinco restrained the growth of government expenditure. (Ihori, Doi and Kondo, 2001). "The general government financial balance in FY 1999 was 10 percent of GDP, with a gross debt of over 108 percent. The inclusion of the surplus on social security reduced that deficit to 7.8 percent, and even that figure was the highest among G7." (Ihori, Doi and Kondo, 2001, p. 353).

3.3 Turbulence in the bank system

One quarter of all bank loans in Japan were related to the property market. In 1991 when the property market began to fall, the banks increased borrower's lending to cover up missed interests and principal repayments, the banks could not afford to let the borrowers go bankrupt. The property value peaked in 1993 and kept stable until around 1998 even though land prices had been going down from around 1992, and by 1998 they had gone down around 60 percent in the 6 biggest metropolitan areas. The banks kept on churning out loans to building projects that were never going to pay off, the non performing loans (NPL) piled up in the early 1990's and it became quite clear as the millennium approached that many of the companies would not be able to pay their debts to the banks and loan foundations because they were not generating sufficient profits and everyone waited and expected the government to find a solution to this nationwide problem (Alexander, 2002).

"… in addition to the amount explicitly stipulated as "real estate financing", the majority of the fund intended for "other purposes" (over 20% at the peak) were actually loans to non-banks that were ultimately for real estate financing". (Yoshikawa, 2001, p. 59).

In 1990 the banks in Japan were told to ease off lending to the public and real estate prices kept on rising until 1991 when they plunged, starting in Tokyo and then spreading to other metropolitan cities that were also affected by the real estate boom that had taken place. However, this did not happen overnight, it took about 3-6 years for the real estate market to calm down (Takafusa, 1994).

Banks and other institutions that became insolvent did so by not only carrying huge amounts of bad debts but they were also untruthful on their records, trying to conceal how great a problem they were carrying. For example when Hokkaido Takushoku Bank went under the books said they were carrying ¥1.15 trillion in bad debt, however, the MOF revealed it was twice as high or ¥2.2976 trillion. We can safely reduct from this information that there was something really wrong about the corporate governance (Yoshikawa, 2001).

Banks seemed to be doing their own thing when it came to distributing money and even though it was clear they needed to restructure and change their tactics, no actions seemed to be taken. Their excuse for paying out dividends were that if they didn't do it the banks would loose credibility, something they were not willing to gamble with, the same was said about suggestions from outsiders regarding pay cuts as a part of a restructuring method (Yoshikawa, 2001). "From 1993 to 1997 Japan's city banks alone distributed over ¥1 trillion in dividends. Moreover, the payouts were maintained at an extremely stable level of around ¥220 billion per year." (Yoshikawa, 2001, p. 58).

The BOJ's exchange rate targeting could be seen as a failure mostly on account of two reasons; firstly, and more obviously than the second one, because of the bubble economy and because of the excessive monetary expansion to soften the appreciation pressure that led to economic and financial instability, and secondly, compared with other floating economies, the monetary policy response was asymmetric that is restricted to appreciation phases which only added to the liquidity trap Japan was facing (Danne and Schnabl, 2008).

The BOJ condoned a money supply growth excessing 10% out of the normal pattern. A fiscal stimulus was not welcomed by the MOF but in May 1987 it approved a ¥6 trillion deficit spending package, by that time the economy was already roaring and it seems like the MOF and BOJ were just adding oil to the fire, since the MITI (Ministry of International Trade and Industry)[2] did not anticipate the arrival of the asset bubble, but was naive enough to believed that Japan's land and stock prices were shooting through the roof because of Japans economic strength, not that it was heading towards a major crisis. As Saito says in the book The Japanese Economy in the 1990's: Problems and Prognoses, the government should let the weak firms, financial institutions and banks that

[2] Later called METI (Ministry of Economy, Trade and Industry) when the MITI merged with other ministries related to other economic labor, which happened in 2001.

overinvested during the bubble period years fall so the economy can be rectified and so it can normalize and stabilize (Kano, Noguchi, Saito and Shimada, 1993).

4. The Aftermath of the Crisis

During 1985-1988 the currency of the country skyrocketed, moreover land and stock prices went through the roof. Thereafter, or 1988-1991, commonly referred to as the bubble period, when Japan's economic strength seemed to come out of nowhere and took the world by storm, Japanese investors went around the globe looking for feasible assets and negotiated with their counterparts in other economies. They were the superpower of the time, but in 1991 the bubble burst and the Japanese economy took a turn for the worse, it stayed that way until the late 2000's and is only now showing signs of recovery. This period has been referred to as the post-bubble recession period, the lost decade or even the two lost decades.

4.1 Government response

In the late 1980's the money supply was expanding by 10 percent a year and this continued throughout the bubble period. However, it shifted to negative growth from the 1990's onwards. Many economists say that one of the main causes of Japan's decline during the 1990's is because of BOJ's sudden decision to weaken the money supply, which should have remained stable. Moreover the BOJ should have enforced monetary stringency much earlier, to try to soften the blow of the market, as asset prices rose so high so quickly (Yoshikawa, 2001).

The overvaluation of the yen finally stopped in the late 2000's, but no-one knows for sure why it stopped, whether it was due to interventions, the monetary policies of the Japanese government or the even the measures taken in the United States. Whatever the reason the real yen exchange rate was reduced by around 21 percent (Hamada and Okada, 2009). "The overly restrictive monetary policy drove the Japanese economy into a severe lengthy liquidity trap. Conventional monetary policy was neither sufficient to recover its desirable price levels nor an appropriate exchange rate, both of which are needed to revive the economy when the yen was." (Hamada and Okada, 2009, p. 218).

> An important economic point here is how fast bank deposits and loans expanded. From 1980 to 1990, the deposit balance in the

> economy expanded at an annual rate of 9.3 percent and the loan balance at 9.6 percent. Unlike in the 1980s, the deposit balance and the loan balance diverged in the 1990s. From 1990 to 1999, the deposit balance grew at an average annual rate of 2.4 percent and the loan balance at 0.7 percent. From 2000 to 2008, the deposit balance grew at 1.7 percent annually, however the loan balance decreased by 1.9 percent, indicating the divergence of the deposit balance and the loan balance became more significant, suggesting the Japanese credit market has changed greatly in the past three decades.
>
> (Chang and Huang, 2010, p. 237).

The MOF gave in to pressure regarding larger expenditure budgets and fiscal measures, but the measures taken by the MOF had no effect, they actually managed to increase the fiscal deficit, which was obviously not their intention. The MOF meant to prevent the economy from taking a hit that would be hard or even impossible to get over, trying to keep the rate of the currency up so it would facilitate exports. "The planned bond-dependency rate rose from a low-point of 7.6 percent in fiscal year (FY) 1991 (initial) to 18.7 percent in FY 1994 (initial)." (Ihori, Doi and Kondo, 2001, p. 352). More than doubling what it had been only 3 years earlier (Ihori, Doi and Kondo, 2001).

In the present, monetary models that are applied for business cycle analysis and optimal policy design, share the characteristic that the stock of money has a marginal importance in determining the balance of the economy. In many cases the models neglect looking at monetary aggregates, and if they do, specifications and predetermined levels of output are applied, and thus the money plays little part in amplifying and/or elongating over time output and inflation fluctuations. Monetary policies in Japan have been blamed for the macroeconomic problems of the country at least since 1998 at least. The monetary policies of Japan were very restricted from that time and remained so until 2003. This is believed to have contributed to the recession and the deflation going on for many years longer than it should have been. The situation has, however been changing slightly since 2003 (Canova and Menz, 2010).

“Japans capital surplus may not last forever, nor will it turn Japan into a superpower, but it is still having a profound effect on Japan and on the world.” (Emmott, 1989, p. 255). That was said about Japan in 1989 in discussion on the Japanese miracle. It was argued that Japan would become a leading nation in the Asia-pacific, which in fact it has become, and that it will affect how Japan survives the first quarter of the twenty-first century as a nation of pensioners. Because the fact is that the number of elderly people in Japan has grown faster than that of any industrial nation in the world (Emmott, 1989), and with the highest life expectancy of 82.6 years for 2005-2010 and 87.1 for 2045-2050 (United Nations, 2006, p. 79). The Japanese population is growing old rapidly, it is believed that those over sixty-five will surpass 16% by 2000 and 20-25% by 2020, which compared to other industrialized countries, let alone Asian countries, is very high (Emmott, 1989).

4.1.2 Fiscal policy

The fiscal policy implemented in the 1980’s was very strict and prohibited any excess capital flow to projects that were not on the given fiscal years (FY) budget list. It was called the zero growth ceiling policy, and was implemented for all fiscal expenditure sections of the government. And so when funds were cut, for example in the University of Tokyo many buildings became dilapidated from neglect, there simply was no capital in the budget for fixing what needed to be fixed, the funds intended for maintenance were cut by 30 percent. The same can be said about other government institutions. Luckily, the zero budget growth ceiling was abandoned in the 1990’s (Yoshikawa, 2001).

> In place of fiscal policies during the 1980’s, the government had adopted an entirely different approach during the early 1990s whereby fiscal expenditures became a main pillar of Japan’s economic stabilization policy. However, this resulted in a dramatic expansion of government budget deficits, so fiscal reconstruction emerged as a major issue.
>
> (Yoshikawa, 2001, p. 31).

> Japan’s fiscal situation in 2000 is the worst of any G7 country, having deteriorated rapidly with the collapse of the “bubble

> economy" in 1991 and the deep and prolonged period of economic recession which ensued, and from which recovery has been slow and modest despite the implementation of counter-cyclical fiscal policy.
>
> (Ihori, Doi and Kondo, 2001, p. 351).

Japan's fiscal deficit is the worst out of all the OECD countries as of 2008 and financial liabilities have exceeded the nominal GDP as of 2009, even after subtracting the government assets. "Measured by the general government gross financial liabilities, Japan's fiscal liabilities were double the nominal GDP in 2010." (Fukuda and Yamada, 2011, p. 448). This suggests that Japan's fiscal deficit is much worse than any of the PIGS (Portugal, Ireland, Greece and Spain) countries that have experienced problems with their fiscal policies after the global financial crisis. In the 1990's the government liabilities were close to that of other OECD countries, but then accelerated from 1992 to 2000 when gross liabilities doubled and net liabilities quadrupled, and yet there doesn't appear to be a simple solution the fiscal problems the country's facing and the liabilities have become exceptionally high since the 1990s and the late 2000s (Fukuda and Yamada, 2011).

The Heritage Foundation's *Index of Economic Freedom* ranks Japan as the 22nd freest economy in the world, securing a ranking of 17th place for freedom from corruption. "But Japan ranks a deeply disappointing 145th place for fiscal freedom, out of 179 countries, according to the *2012 index of economic freedom"* (Scissors and Yokoe, 2012, p. 3)

4.2 Economic outlook

Japan's low interest rate policy was accompanied by a rapid expansion of money and credit supplies. Easy money poured into the asset market and sustained asset inflation. The discount rate dropped to 0.5 percent in 1991 (the Heisei recession) and was sustained that way until 2001. Not only was it lowered to 0.5 percent but in 2001 the Central Bank of Japan (BOJ) lowered it still to a new all time low of 0.1 percent maintaining it that way until 2006, thus receiving the name Zero-interest-rate policy (ZIRP). In July 2006, BOJ got rid of the ZIRP, raising the call rate to 0.25 percent and the official discount rate to 0.4 percent. The bank then further increased the rate to 0.75 percent in March 2007, maintaining it that way until September 2008 and then decreasing it yet again to 0.3 percent. The zero-interest-rate policy is a major factor in the hindrance of the banking system to impact economic growth in Japan (Chang and Huang, 2010).

"In April 1996 three key financial laws were passed in an effort to maintain the stability of Japan's financial system." (Yoshikawa, 2001, p. 75). However the timing of the policies was really bad, the policies were meant for companies to assess the soundness of their own assets, in their asset evaluation criteria. However some large-scale financial institutions went under in the autumn of 1997, shaking the foundations of the business sector. The Japanese people were not notified how the government was tackling the matter and many did not understand why public money was being pushed into the financial system. Stock prices went down and before they knew it they had a full on credit crunch (Yoshikawa, 2001).

According to the World Bank, Japans Gross Domestic Product (GDP) was 42.831 in 2010, it has been, and usually is, one of the top 30 in the world, after the country industrialized (World Bank). The negative GDP growth recorded from 1997 through 1999 can largely be attributed to the reverse thrust from the man-made disaster of the credit crunch and policy failure (Yoshikawa, 2001).

The Japanese government did not appear to acknowledge the slow growth of the economy, which began to drop in the early 1970's, it was set on high growth well into the 1990's. But as other industrialized countries know there can't be high growth forever and sooner or later it will drop to around 2 percent, like in other developed countries. As I mentioned earlier, this took the Japanese government a long time to figure out and many years to penetrate through the system. The government implied that the two oil crisis's and the strong currency were the main factors behind the slow growth and believed for the longest time that it was just a temporary glitch in the world markets. Today it seems as if the government has realized that the slow growth is there to stay and that super high growth will not return and propel the economy in the near future.

Even though it looks like the government didn't do anything to try to stop the crisis, it has in fact tried tackling the matter in a couple of ways. Prime Minister Ryutaro Hashimoto orchestrated a procedure called *The Big Bang* in 1996. *The Big Bang* was meant to clean up the bad loans and tainted business procedures formerly acknowledged by his predecessors and the MOF, but experts claim it's too little too late, the fiscal deficits the government started running up in 1991 with the procedures implemented by the government didn't boost the economy, the economy didn't get the stimulus it really needed and it didn't start running on it's own like the government had hoped for, so the fiscal deficits started piling up (Alexander, 2002).

4.3 Political turmoil

LDP or the Liberal Democratic Party has had a huge impact on the economy in Japan, in addition to being the leading political party in Japan for over 50 consecutive years, or since just after the WWII. It is the only political party in the world to retain power for such a long time. In August 30th 2009 the LDP lost for the first time excluding 10 months in 1993-1994 to another party called the Democratic Party of Japan (DPJ) and this was no defeat by few votes, the party got 308 out of 480 seats in the Diet, breaking all previous records held by the LDP. Only seven DPJ candidates did not get into the Diet, many LDP politicians lost their seat accordingly, even former ministers and prime ministers. This was a great shock to the LDP, a political party that had won the election in 2005 by a landslide, gaining a supermajority of two-thirds of the votes. The reason for the party's success is believed to be its personal favors to constituents, the constituents voted for people that would bring money into their businesses and prefectures. High-ranking politicians have eased the way for many firms, enabling access to loans from banks and other advantages. These politicians have later been granted a nice position in these companies after resigning from politics; this has been seen time and time again throughout the decades and is a common practice in the Japanese economy. Moreover, votes from the countryside tended to sway in LDP's direction and those votes counted for more than the urban votes, making the playing field a little un-even. In order to gain those votes the people running for office developed a type of patron-client relationship making it almost impossible to lose those votes to the DPJ (Krauss and Pekkanen, 2010).

> That the LDP strongly supports the industry is indicated by the fact that Japan spent 10 percent on public works projects and related land acquisition in 1996; the comparable figure for the United States and European countries was just over 2 percent. Were banks to get serious about cleaning up their bad loans and cutting lending to unprofitable companies, the construction industry would be at the top of the list. The LDP, however, has been extremely reluctant to promote a strict assessment by banks of business profitability that would have the effect of undermining the construction industry.
>
> (Alexander, 2002, p. 13-14).

After Koizumi resigned in 2006, the LDP has not been stable enough with their political agendas and this has set off warning bells to the voters, which in turn have chosen to support DPJ. Coincidentally many floating voters seem to have voted for the DPJ rather than the LDP, in addition to the rural people that before had counted on the LDP, they felt betrayed by the change in what the LDP emphasized on. Wanting to cut ties to the elite bureaucracy and put policy-making only in the hands of politicians.

Since the LDP lost the election in 2009 it has been imperative that it restructures and changes the ways it portrays its political agendas. It is not easy to go from two-thirds to one-fourth of seats in the Diet. It must have shook the party up and get them to take a rapid turn towards other political goals, goals that the voters agree with.

If competition is great in a political system, it can lead to a fiscal policy that results in a smaller deficit, which eventually is what every government should strive for. Which is why, less debt will be stacked up in countries fortunate enough to have more competitive political systems. Moreover, the dominant political party/ies, generally in command, implement a fiscal policy resulting in smaller deficits. Since Japan has been ruled by the LDP for the past 50 years it has had no political rivalry to speak of. When a political party dominates the politics for a long time, they may be reluctant to tighten their fiscal policies, as that would imply that they had done something wrong in the past which they will never admit to, that is why they would rather keep on accumulating debt and hope for the problem to solve itself (Skilling and Zeckhauser, 2002).

The fact that it has become increasingly expensive to run for office has led to candidates seeking out wealthy corporations in order to generate money for their campaign, who offer up large sums of money in return special treatment, more than the generic benefits, when the candidate takes office. Thus, this has changed and politicized the national bureaucracy and the national economic policies (Pempel, 1998).

The political situation before the bubble burst was the fruit of Tanaka Kakuei's ideas about economic growth, when he failed, Fukuda's economic stability was became the main focus, it succeeded in calming the inflation. However it "…significantly reduced the options of Japanese public policy in addressing the issues of income distribution."(Gao, 2001, p. 213). Thus the Japanese economic system started relying on unyielding government protection of the weak rather than improving the companies competitive positions on the market (Gao, 2001).

When the government creates jobs for its citizens it seems to make them happier, and so many politicians in power tend to create some jobs right before the conclusion of their term, and with impending elections. In this way they guarantee that voters will remember them and vote for them again. However, the voters do not seem to mind or realize that the inflation rate goes up around the same time as these jobs are being made. Thus this becomes a vicious cycle that revolves around election terms (Ito, 1992).

4.3.1 Keiretsu

The Japanese style of familiarity between companies has been noted by other nations especially by the United States, which started teaching Japanese practices in industrial relations in the 1980's. It seems like some of Japans success is due to this kinship. Cross-share-holding between a bank and various companies in many fields of operation, work together to provide what the other needs. Companies that do business with each other, and that have formed economic relationships seem to have a better possibility of growing as opposed to the ones that have not formed this type of bonds. Companies can in this way easily calculate what is required of them to generate profits, as they know the other company will do business with them and know roughly what quantity the given firm will be asking for, in that way it is easy for them to make decisions regarding manpower and investment that the company wants to take part in. This enables companies to grow without taking risks that might threaten the company. These types of relationships are called keiretsu. When companies had formed these alliances they started branching out in the late 1980's, many of them started investing in properties and market shares in the United States, some suggest it is at the expense of declining US manufacturing industries. Many of the oldest most respectful skyscrapers in the skyline became the property of Japanese tycoons and many Americans were against these transactions, then when the bubble burst many of these buildings went back to American owners.

The Keiretsu relationship has had a dramatic effect on the Japanese economy and has in many ways been hurtful for the banks and other institutions related to each keiretsu, because of the cross-share-holding, it can be analogized to a house of cards, if you take out one card, the whole thing falls apart, and thus the banks and other institutions do what they can to keep the other up and running and many have there for plunged their companies into debt that will be hard to get rid of, unless the economy takes another leap forward. This type of relationship has been encouraged by the LDP, whereas the affiliation gets easy access to the government employees and the LDP politicians in return get jobs in one of the companies related to that keiretsu when they put an end to their political careers.

"…Japanese banks are allowed to own up to 5% of the outstanding shares out of their client firms." (Kang, 1997, p. 30). Most of the Japanese firms maintain strong ties between the bank and themselves, usually the bank that lends them the most even if they are not joined in the keiretsu affiliation. This compared to the United States where banks are prohibited completely from owning shares in companies they do business with (Kang, 1997).

Selling assets, closing plants and employee layoffs have been practiced and should be practiced in modern Japan but the question is are they doing enough? It seems like when a bank or a block-holder owns a substantial amount of the company, it becomes more approachable when restructure is needed. The takeover-induced restructuring, practiced in the United States is not very popular in Japan, where a certain code of conduct applies to buying and restructuring older companies (Kang, 1997).

4.4 National debt

The public debt of Japan has been very high for a long time and was estimated at just over 220 percent of GDP for 2010 (IMF). The Japanese government leans towards a special kind of macroeconomic theory, based on ideas of the English economist, John Maynard Keynes. Usually referred to as Keynesianism or Keynesian theory.

More than two-thirds of the Japanese debt was accumulated from 1995. This is an unprecedented level for an advanced economy, not presently or recently involved in war. Its only increment is that Iceland and Ireland are in crisis, while Japan is not since 95 percent of debts are held by domestic entities, led by banks and insurers (Scissors and Yokoe, 2012).

> A traditional Keynesian macroeconomic prescription is aimed at curing the imbalance of excessive capital expenditure by firms that lead to underutilized productive capacity and a consequent excess aggregate supply by increasing aggregate demand with tax cuts, public work projects and the like. […] creditor-controlled firms excessively direct their capital investment towards the expansion

> of existing facilities, increased market shares in existing products, minor variations in product design and other low-risk, low-return ventures. This strategy should work well as long as new markets open to provide a growing aggregate demand for such products. This characterized Japan's reconstruction during the postwar period and firms' explicit quest for market share rather than profits. [...] Faced with persistent excess aggregate supply, Japanese firms have been forced to lay off huge numbers of workers in mid career. The practice of life long employment means that few firms know how to hire such workers. Consequently a serious social problem is developing.
>
> (Nakamura, 2001, p. 339).

> Keynesians believe that major disturbances which affect the aggregate demand are the source of business cycles. There are many ideas about the major source of these shocks and about the nature of the mechanisms that prolong their effects. Keynesians also tend to believe that prices and wages are sluggish – that is, that prices and wages do not change quickly enough to equate demand and supply.
>
> (Ito, 1992, p. 81).

The Keynesian theory seems to have facilitated the Japanese government. The Keynesians believe the government can correct various deviations from the economy, like demand from supply. By improving monetary and fiscal policies it is possible to adjust to economic shocks (Ito, 1992).

> Japan's crisis is twenty years in the past, yet Keynesian stimulus has been continuously applied since then. The results are plain. Despite racking up the largest peacetime debt in modern economic history, while entirely failing to grow, the government continues to respond to every downturn with more stimulus. This has accomplished nothing. Yet ending large-scale deficit spending is seen as a threat to the economy. So spending continues, reform is nonexistent, and Japan trudges along.
>
> (Scissors and Yokoe, 2012, p. 2).

Even though the government turned to a series of fiscal stimulus packages during the early 1990s to try to contain the budget deficit problems plaguing the economy of Japan, it simply wasn't enough, the budget deficit has been accumulating for more than two decades now. The government has tried to lower the deficits, in 1996, 2000, 2005-2007 however they keep on rising, and the deficits to GDP ratio have increased from 2.5 percent in 1993 to around 8 percent by the end of the 1990s and most of the 2000s too. The debt to GDP ratio has also increased from 74 percent to 200 percent by the end of 2000s (Doi, Hoshi and Okimoto, 2011). "From 1999 on, Japan has the highest debt to GDP ratio among the G7 countries. The ratio exceeded 200% after 2010 […] The net debt to GDP ratio stood around 120% for Japan in 2010." (Doi, Hoshi and Okimoto, 2011).

Killing and Zeckhauser have put forth the notion that governments accumulate debt because the citizens indulge too much in spending, and therefore their votes go to the political party that aims on keeping taxes at a low. The voters do not seem to understand that accumulating deficits can hurt the economy and the country in the long run, resulting in bankruptcy of the entire country. Moreover, some believe that by holding the taxes down now, they can get future generations to share the burden and lighten their load. And thus deficits and debt are the obvious answers (Killing and Zeckhauser, 2002).

Japans economic growth after 1991 has been slow with an annual growth rate of just over 1 percent, which the nation is still adjusting to. Since the high speed growth era, the government has up until recently not realized high speed growth is not returning anytime soon (if ever), and is just now in recent years admitting that it needs to adjust its policies to facilitate this slow growth. Over a decade now or up until 2008, the growth rate has just been 1 percent or just over, making it the slowest among the G7 nations (Chang and Huang, 2010).

Drastic changes in the Japanese workforce have been taking place during the past decade; in 1974 there were only about 40 percent of the workers employed by large corporations and companies, while the rest were self employed or worked in family businesses. However, these numbers changed drastically after 1985 when the firms employed around 80 percent of the Japanese workforce.

The large firms with the latest technology and the best service sectors gained increasing value in the national economy. Simultaneously, the nation was growing older and those over 65 went from around 7 percent of the population to around 14 percent in 1995, a doubling that had taken more than twice as long in the United States and over a 100 years in France. The growth is so rapid that the ratio between workers and pensioners will increase from about 7:1 in the 1970s to 4:1 in the 2000s and 3:1 in 2015 (Pempel, 1998).

5. Lessons to be Learned

There have been many theories put forward as to how the government should stop the crisis and overcome the past two turbulent decades. The country's unemployment rates have been kept low compared to other OECD countries, but it can be questioned at what cost. For example, the government itself employs many people for various government projects and it can be argued that it hires more people than necessary simply to see the unemployment rates drop. Moreover, many believe the main reason is the LDP, which dozed off due to lack of competition. Others believe the main reason for the bad economy is the keiretsu groups, dragging each other down and not admitting defeat when it was due, then there are those that remain firm on the idea that banks and loan foundations are the culprits for dragging the nation into a depression that went on for more than two decades.

The Japanese firms have tried some of the western type methods to try and stop the companies from going under. For example, Japanese businesses and corporations are more and more taking up western models of companies. "They are hiring employees under term contracts rather than life employment and are offering them higher cash earnings today rather than fringe benefits and future promotion and pensions." (Alexander, 2002, p. 51-52).

Fiscal and monetary measures of the government have also been discussed and many feel that the government did not do so well when it came to those imperative parts, for example in Yoshikawa's book:

> The experience of the 1997 policy blunder provides us with two invaluable lessons.
>
> I. It is impossible to push through fiscal reconstruction during severe recessions, and stop-and-go implementations must be avoided.
>
> II. The judgment of economic conditions should never be changed to politically facilitate the adoption of particular policy goals.
>
> (Yoshikawa, 2001, p. 39).

The government has made its efforts on bringing the fiscal deficits down with various measures, many of them have seemed to work, but on the cost of other government goals.

Overinvestment and low returns on capital in Japan may in fact be largely due to the MOF's promise not to let any bank go under it also added to the hold up of recognizing the size of the problems the country needed to face after the asset-price bubble burst. Instead the solution of the government was to wait it out and close their eyes to what was happening, a procedure that would come back to haunt them a little later (Alexander, 2002).

> Another shock to the Japanese psyche was the decline in the government's willingness and ability to prop up the banking system. This shift in policy has been quite explicit: MOF has announced that it will not feel compelled to come to the rescue of small banks or to bail out large ones after April 2001.
>
> (Alexander, 2002, p. 8).

In 1995 around the peak of the unusual appreciation of the Japanese yen it is argued that exchange rate, calculated by the GDP deflators of the yen/dollar appreciation was around 78 percent higher than before the Plaza accord. This is believed to be a major factor in the long lasting recession in the country, with the combination of monetary and exchange rate policies, bringing the economy into a liquidity trap that the government had more than a hard time getting out of. It wasn't until 2003-2004 that the government managed to get out of the persistent recession and drag itself out of the liquidity trap (Hamada and Okada, 2009).

The Japanese government is at serious risk and it has not taken the threat seriously enough. Japan's taxes are not high enough, even though the government raised the consumption taxes from 3 to 5 percent in 1997. If the government wants to stabilize the debt to GDP ratio, it has to implement a tax increase like no other, deviating from the fiscal policies of the country that have been executed by the government for more than 30 years. The fiscal policy of the country is believed to be unsustainable even though a different political party is now leading the government (Doi, Hoshi and Okimoto, 2011). "If the government fails to reduce the primary deficit by increasing the taxes and reducing the expenditures and transfer payments, Japan would be forced to reduce the value of government debt through either inflation or outright default." (Doi, Hoshi and Okimoto, 2011, p. 432).

The Liberal Democratic Party has ruled for so long that the people of Japan, many of whom have never known any other agendas than those of the LDP, do not realize that political changes are desperately needed every few of years to keep the economy on lookout. By active political differences the laws set would benefit the country as a whole not only specific groups of people. The keiretsu affiliation has given the impression that no outsiders will be allowed to enter the Japanese economy. The Japanese banks have put their mark on the economy through the years and have been guided by the Ministry of Finance as well as the government, but it can be verified by the information above that having only one ruler governing for so long seems to have had a very bad effect on the economy, and by not having fresh perspectives on the policies and laws passed through the decades it is almost certain that the government has missed out on some important outlooks and solutions. Even though the government implemented many rescue packages in an attempt to revive the country's economy, nothing seemed to work, and Japan is now deeper in debt than ever.

There have been many speculations as to how the Japanese government should have handled the crisis or even how they should have governed the country before it hit. But one thing is certain; it is easy to have 20/20 hindsight. Japan has also been unlucky, first the oil shocks followed by hyperinflation and the ZIRP and now the latest earthquake followed by the tsunami. I think the government has really tried to fix the economy but their actions may have been too small scale, but I think they ought to be able to overcome this, especially given their strong export oriented economy. The people are apparently not willing to have their taxes increased and have become accustomed to a certain lifestyle they are not willing to give up. Moreover the slowing growth of their economy, making them take decisions based on a double digit economic growth rate they did not have, making these decisions the wrong ones, and thus falling deeper into the crisis and the lost decade.

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