



HÁSKÓLI ÍSLANDS

Hugvísindasvið

Japan's Lost Decade

Lessons for Iceland

Ritgerð til B.A.-prófs

Eva M. Kristjánsdóttir

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Háskóli Íslands
Hugvísindasvið
Japanskt mál og menning

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Abstract

After World War II Japanese society went through substantial political, social and economic reform. Change in economic management generated growth and prosperity. Both gross national product and gross domestic product rose considerably in a brief period of time. The yen appreciated, public savings increased and both domestic and foreign investment advanced. In the 1980s the Nikkei 225 stock index surged and reached its peak just before the break of the decade. Real estate prices escalated likewise and property prices in Japan were the highest in the world at the time. These asset price bubbles had become unsustainable and Japanese authorities, recognizing this, raised policy rates. This immediately shattered the price bubbles, sending the Japanese economy into a deep recession of prolonged economic stagnation. Banks and businesses took most of the heat, losing their equity shares and experiencing devaluation of their creditors' mortgages. Non-financial corporation struggled to meet their loan installments, leaving banks and lending institutions with massive accumulation of non-performing loans.

In the wake of this economic collapse, Japanese authorities seemed indifferent, showing reluctance to take any real action. When they were forced to deal with the dire situation at hand, their policies were somewhat hesitant and insufficient.

Through numerous fiscal stimulus packages and capital injections into bad off banks and financial institutions in the 1990's by the Japanese government, the economy gradually started showing signs of recovery. Japanese authorities financed their rescue operations by borrowing enormous amounts of money, leaving Japan one of the heaviest indebted countries in the world. The decade long economic depression in Japan has become to be known as "the lost decade", describing both stagnation in the economy and loss of opportunity.

Iceland is currently faced with a situation not unlike the one Japan was in some 20 years ago. The Icelandic authorities seem to take after their Japanese counterparts in their initial reactions, seemingly lacking earnest strategies to mend the ailing economy.

Although the situation in Iceland is not entirely the same as in Japan in the 1990's there must be some lessons to be learned from Japan's lost decade to prevent the Icelandic economy from heading down that same road.

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Preface

In 2008 the world economy experienced its worst decline in decades. One of the countries that suffered the biggest blow was Iceland. Three of the largest local banks were nationalized in a short period of time. The country's economy was in a full systematic crisis. The national currency, the Icelandic krona, plummeted. The local stock index fell catastrophically due to the bankruptcy of the country's banks. The formerly booming real estate market slumped. The reasons for this economic crisis in Iceland are complex and not to be assigned solely to the bad state of the world economy in whole, or to the reckless executives of the banks. Interestingly, the situation and the events leading up to the economic crisis in Iceland are not unprecedented. A very similar situation occurred almost two decades ago, when the Japanese asset price bubble burst and the second largest economy in the world suffered a major blow. Although the situation in Japan in the 1990s and the ongoing crisis in Iceland are not entirely the same, there are several distinct similarities. Like in Japan in the 1980s, the years before the 2008 banking crisis in Iceland were characterized by heavy spending and rise in commercial real estate prices. In both cases the results were enormous, unsustainable asset price bubbles, which when they burst, devastated the countries' economies and business environment, throwing them into deep economic depression.

More than two years into the Icelandic economic crisis, there are not many signs of any real recovery. The national debt is big as ever, and the country's economic recovery is depending on the support of the International Monetary Fund (IMF). Can it be that Iceland is heading into a "lost decade" of economic stagnation and lost opportunities much like Japan experienced in the 1990s? If so, Iceland can learn from Japan's experiences to prevent the situation from becoming as catastrophically severe. The following will examine the events leading up to Japan's economic crisis and the measures taken by the Japanese authorities to deal with the situation. Finally, possible lessons for the Icelandic authorities from their Japanese counterparts will be discussed.

The Japanese Economic Miracle

After its atrocities in the Second Sino-Japanese War and World War II, Japan faced serious scrutiny by international society. It was placed under the control of General MacArthur by the Allied Powers. Some of the Japanese military leaders were prosecuted and convicted of war crimes and crimes against humanity in the Tokyo Trials. However, all members of the Japanese imperial family were exonerated and the extent of the Tribunal was nowhere near as massive as the Nuremberg Trials in Germany.¹ In the following years, major reconstructions were made in several areas of Japanese society under the guidance of the United States government. A new constitution was introduced and the political landscape changed with a democratically elected senate and expanded suffrage. Yet, the most revolutionary reform in Japanese society post World War II is without doubt the total transformation of its economy. In a few decades Japan rapidly developed into one of the world's major economic powers. The road to economic reform was paved by incorporating western ideals in its political infrastructure. The United States saw the westernization of Japan as an important move against their idealistic adversary in the east, the Soviet Union. They saw Japan as an ideal buffer-state between the west and the USSR and Communist China. With the outbreak of the Korean War in 1950, Japan became an extremely important ally to the Western powers. American political advisor George F. Kennan, one of the visionary architects of the famous post-war Marshall Plan and a key advisor on the American side in the Cold War, called transforming Japanese society "the most significant contribution [he] was ever able to make in government" apart from the said Marshall Plan.² The rapid economic expansion of this otherwise traditional society is popularly known as "The Japanese post-war miracle".

From Zaibatsu to Keiretsu

The old family-based Zaibatsu conglomerates were targeted for either complete dissolution or reorganization during the U.S. occupation of Japan. However the

¹ John Dower, *Embracing defeat* (New York: Norton, 1999), 323–325.

² George Frost Kennan, *Memoirs 1925-50* (Boston: Little, Brown, 1967), 393.

termination of these companies was never entirely achieved. Domestic support for a vertically structured, family-based chain of command played a big part in the pullback of that plan. Moreover it was considered constructive for the growing economy of Japan. Nevertheless the infrastructure of the conglomerate changed. The vertical chain of command, with one family serving as the head of the company, decreased. A more horizontal integration, connecting companies across industries, helped coordinate and link together the old Zaibatsu as a new form of conglomerate, now called Keiretsu. In a way the Keiretsu enjoyed the best qualities of both: vertically integrated family structure and the alliances brought on by horizontal cooperation.

Government Affiliations

Prime Minister Hayato Ikeda is considered one of the most influential figures in the Japanese economic miracle.³ During his regime, the National Income Doubling Plan was introduced and implemented. The National Income Doubling plan, or the Double Income Plan, was intended to double the Gross National Product in a decade. Ikeda projected an annual growth rate of 7.2%. To accomplish this goal, the Ikeda administration lowered interest rates and implemented tax-reductions to encourage investment. Moreover, the government increased public works, concentrating on the country's infrastructure, building roads, bridges, highways, railroads and subway systems. The growth was much faster than anyone had anticipated, even Ikeda himself. By the middle of the decade the average annual growth was as high as 11.6%. Then again, the measures Ikeda took to achieve his goals were somewhat controversial. He emphasized heavy industrialization, such as shipbuilding and electric, coal, and steel production, in order to maximize economic growth.⁴ While economic growth was certainly achieved, it might have been at the expense of other important issues, like security, social and environmental affairs, social equality and even democracy. Ikeda's fixation on economic growth is perhaps mirrored in his particularly distasteful comment, "it is unavoidable that [the government's policy of heavy

³ Takafusa Nakamura, *The Postwar Japanese Economy: Its Development and Structure* (Tokyo: University of Tokyo Press, 1981) and Chalmers Johnson, *MITI and the Japanese Miracle: The Growth of industrial Policy, 1925-1975* (Stanford: Stanford University Press, 1982).

⁴ Johnson, *MITI and the Japanese Miracle*, 211.

industrialization] will probably drive a few small businessmen to bankruptcy and suicide.”⁵ By the time Ikeda left office in 1964 the GNP was up to an astounding 13.9%. Ikeda’s heavy-industry policy also led to massive loans to businesses. More often than not these loans were vastly beyond the company’s ability to pay back and even higher than the company’s net worth. The reason this was tolerated was that many of the companies that were borrowing money were Keiretsu. With their closely knit network of alliances and sometimes cross-share holdings with other institutes in Japanese society, they found it easy to borrow from local banks. At the time, capital was tight in Japan, not only for businesses, but also for the small local banks. The smaller banks, lending money to various businesses, turned to the Bank of Japan for a loan of their own. This gave the Bank of Japan leverage over the local banks. Consequently, the companies became indebted to the Bank of Japan.

The Bubble Inflates

Driven by the start of the Korean War in 1950, Japan’s economy started to rise from its post war ashes. Until 1960, gross domestic product grew around 8%, increasing to double digit growth in the sixties. By 1970 the GDP had doubled since the end of World War II. In the 1970s, the growth leveled out to about 4% per year, where it lingered until the burst of the economic bubble.⁶

In order to inject more capital into the Japanese banking system, the Japanese government encouraged people to save their income. The Japanese, whose culture is fundamentally thrifty and minimalistic, did so, giving the banking sector their hard-earned money to gamble with. The yen surged, spurring the Japanese monetary authorities to pump even more money into the market.⁷ The sudden increase of liquidity escalated both foreign and domestic investment, along with a booming stock index. This further increased economic growth. Moreover inflation rapidly decreased in the 1980s. This was not all good news, for the Japanese government feared

⁵ Chalmers Johnson, *Japan, Who Governs? : The Rise of the Developmental State*, First ed. (New York: Norton, 1995), 161.

⁶ Arthur J. Alexander, *In the Shadow of the Miracle: The Japanese Economy Since the End of High-Speed Growth* (Lanham, Md.: Lexington Books, 2002), 24.

⁷ Dick K. Nanto, *The Global Financial Crisis: Lessons from Japan’s Lost Decade of the 1990’s* (Washington D.C.: Congressional Research Service, 2009), 3.
<http://fpc.state.gov/documents/organization/125542.pdf> (retrieved April 18, 2010).

decreasing competitiveness of Japanese goods globally. In order to prevent this, the government switched its focus to containing the rising yen instead of escalating GDP. The Bank of Japan decided to reduce policy rates by 50% in just over a year in 1986 and 1987. The results were massive price bubbles in both stock and real estate markets.⁸ Foreign and domestic investment increased, fueled by enormous sums of borrowed capital.

Real Estate Bubble

Fueled by the Bank of Japan's loosened monetary policy, the real estate market surged. The urban land price index tripled in five years, from 35.1 in 1985 to a 105.1 at its peak in 1990.⁹ In the most expensive districts of Tokyo prices were as high as 100 million yen per square meter at its peak.

Banks and other finance organizations secured most of their loans through real estate mortgages. They based their lending on a trend line indicating that real estate prices would continue to rise. In the fever of escalating real estate prices, credit standards went down. Banks relied on continuing growth in real estate prices, paying no heed to whether their debtors' liquid resources or profits could meet the terms of the loans. No one seemed to recognize that real estate prices could not go upward forever.

Stock Market Bubble

With more money flowing in the Japanese system, investment ventures became increasingly risk seeking. Instead of concentrating their investment in equipment and tools needed to gain competitiveness internationally, Japanese banks and financial organizations invested in stock. Speculation ran high. The higher the risk, the bigger the gains. Stock prices soared and it became harder and harder for speculators to miss their mark. These were high times for thrill-seeking investors. Blinded by success, the investors became careless and relied on a continuing rise in the stock markets. Speculators anticipated continuing growth in the stock index and based their investments on that prediction.

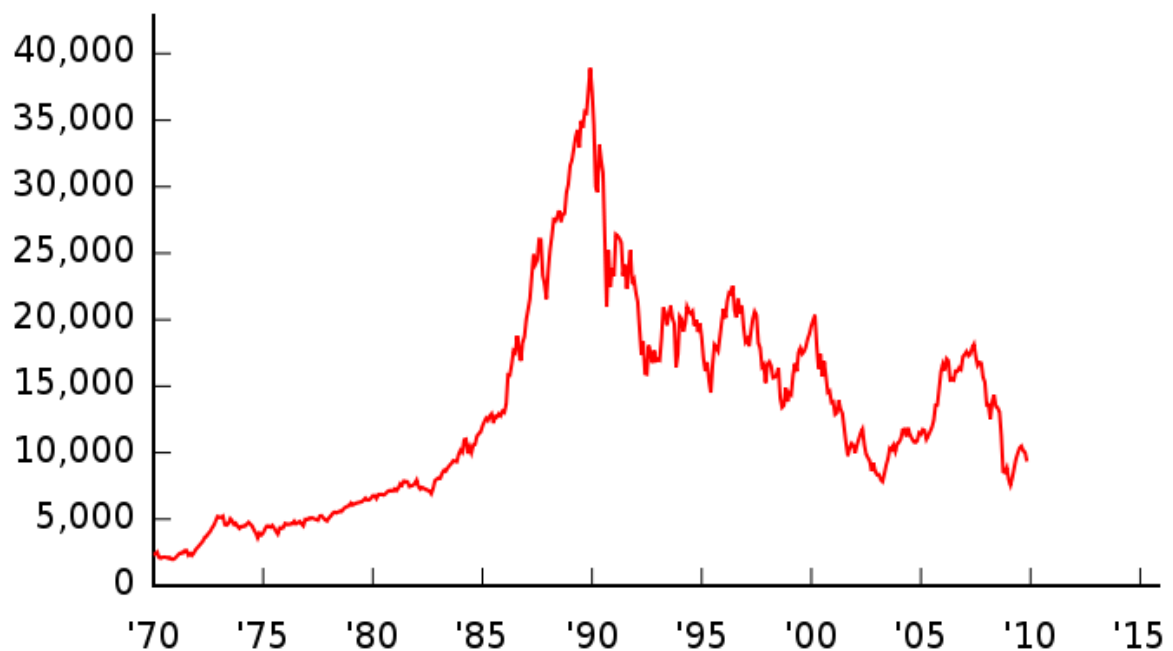
⁸ U.S. Congress, Joint Economic Committee, Policy Lessons from Japan's Lost Decade (Washington, D.C.: Joint Economic Committee, 2008). <http://www.house.gov/jec/Research%20Reports/2008/rr110-30.pdf> (retrieved April 18, 2010).

⁹ Same reference.

To give an example of the extent of the climb in stock prices in the 1980s, the Nikkei 225 index was at 6,000 points in 1980. In less than 10 years, the stock index almost quintupled and reached 38,957.44 points on the decade's last day of trading on December 29, 1989.¹⁰

Figure 1 shows the development of the Nikkei 225 index in the last forty years.

Figure 1 – Development of the Nikkei 225 from 1970 until present.¹¹



The increase in stock investment was largely financed by loans. Due to low interest rates, loans were favorable and easy to come by through the horizontal channels of the Keiretsu. This type of cross-relational lending and leveraged financing, loaning in order to supplement investment, amplified systematic risk. A risk involved in the system of coinsurance. That is that if and when a single unit in the coinsurance system of cross shares and cross relations collapsed, it risked bringing down others with it.

¹⁰ NIKKEI.com, Market, "Nikkei Index". <http://e.nikkei.com/e/cf/fr/market/nikkeiindex.cfm> (retrieved April 23, 2010).

¹¹ Graph by "Monaneko", [http://en.wikipedia.org/wiki/File:Nikkei_225\(1970-\).svg](http://en.wikipedia.org/wiki/File:Nikkei_225(1970-).svg) (retrieved April 21, 2010)

The Bubble Bursts

The abnormal development in stock and real estate prices in the late eighties came to an abrupt end in the early 1990s. The Japanese Finance Ministry, recognizing that the asset price bubbles were unsustainable, raised interest rates. This move immediately shattered the real estate and stock market bubbles, leading to a sharp crash in both markets. The bubble bursting in the early nineties was an agglomeration effect of the collapse of the real estate market and the equity market actuated by the Japanese government's decision to raise policy rates from 2.5% up to 6% in just a few months time.¹²

Estimated losses from the drop in real estate and equity markets were roughly 1,500 trillion yen or more than three times Japan's GDP at the time.¹³ The crash of the real estate and stock markets was very damaging to the economy of Japan and consequently its people.¹⁴

Stock and Real Estate Market Crash

The Nikkei 225 stock index, having peaked at 38,957.44 points before closing at 38,915.87 on the last trading day in 1989, plummeted by almost 50% in the first 9 months of the new decade.¹⁵ By 2003, all the gains made by the increase in stock prices since 1985, had been wiped out.

Real estate prices fell rapidly in 1990 and 1991. The gains made by the enormous increase in urban land prices were completely wiped out by 2000. The ridiculously high real estate prices in Tokyo fell to merely 1% of its peak in 1989. Still, house prices in Japan remained among the highest in the world. After the crash in the real estate market, the trend line suggested that real estate prices would hit rock bottom around 1995, however prices continued to drop progressively for 12 years after that.¹⁶

¹² U.S. Congress, Joint Economic Committee, *Policy Lessons from Japan's Lost Decade*.

¹³ Richard C. Koo, *The Holy Grail of Macroeconomics: Lessons from Japan's great Recession* (Singapore: John Wiley & Sons, 2008), 16.

¹⁴ Martin Fackler, "Take It From Japan: Bubbles Hurt," *New York Times*, December 25, 2005. <http://www.nytimes.com/2005/12/25/business/yourmoney/25japan.html?pagewanted=all> (retrieved April 16, 2010).

¹⁵ Takeo Hoshi and Anil K. Kashap, "Japan's Financial Crisis and Economic Stagnation," *The Journal of Economic Perspectives*, vol 18, issue 1 (2004): 3-26.

¹⁶ Keiichiro Kobayashi. "Financial crisis management: Lessons from Japan's failure," *VoxEU*, October 27, 2008. <http://voxeu.org/index.php?q=node/2483> (retrieved April 16, 2010).

Japan's Great Recession

Following the bubble bursting, recession was inevitable. The Japanese economy was undeniably headed into a period of depression. While nothing could have stopped an economic slump after the prick of these unsustainable asset price bubbles, the actions taken immediately in the wake of the boom were the ones that would determine the severity and longitude of the recession.¹⁷ The ten years following the burst of the asset price bubbles marked the deepest stagnation and economic depression Japan had seen in its latter-days. This period of prolonged economic stagnation is commonly known as Japan's "Lost Decade". Others have dubbed it "Japan's Great Recession."¹⁸

Banking Crisis

The crash in stock and real estate markets was hard on the Japanese banking system. Defaulting on loans increased and the collateral behind these loans more often than not turned out to be much less reliable than initially assumed. Many loans were bound to real estate mortgages, and the slump in the real estate market lessened their value tremendously. Reduced real asset values lessened banks' and financial organizations' collateral. Even if companies who weren't capable of paying installments on their loans would have been sold and their assets liquidated, because of the slump in both the real estate and equity markets, the total sales value would only be a portion of the debt.

Now the carelessness of the banks, having based their loan granting on assumptions of continuing rise in the real estate market, hit home.¹⁹

Furthermore, the banks had recklessly engaged in relational lending, lending money based on personal relations over professional methods of business.²⁰ The banking system found itself in a deadlock. Both financial corporations and non-financial companies could no longer pay the installments on their loans. The banks would gain little by pursuing their debtors for their assets were gone. The banks in turn could not

¹⁷ U.S. Congress, Joint Economic Committee, *Policy Lessons from Japan's Lost Decade*.

¹⁸ Kenneth M. Kuttner and Adam S. Posen, "The Great Recession: Lessons for Macroeconomic Policy from Japan," in *Brookings Papers on Economic Activity*, vol 32, issue. 2 (2001): 93-186.

¹⁹ OECD: *Competition and Financial Markets*. DAF/COMP(2009)11/ADD1. 2009.
[http://www.oilis.oecd.org/oilis/2009doc.nsf/ENGDATCORPLOOK/NT00002EAE/\\$FILE/JT03266122.PDF](http://www.oilis.oecd.org/oilis/2009doc.nsf/ENGDATCORPLOOK/NT00002EAE/$FILE/JT03266122.PDF).
(retrieved April 11, 2010)

²⁰ Nanto, *The Global Financial Crisis: Lessons from Japan's Lost Decade of the 1990s*, 5.

pay off their own loan installments. Instead of taking instant action towards their insolvent debtors, banks and other lending institutions ignored the problem and kept extending loans towards them in order to keep them from filing for bankruptcy. Had these companies fallen into liquidation, their creditors would have been forced to admit write-offs in their books, which they desperately wanted to avoid. This continued lending did nothing but escalate companies' debts, and further extend the pile of non-performing loans. Over time this lack of action began to drain the capital of banks and lending institutions.

Moreover, banks and financial institutions in Japan were allowed to hold a part of their capital stock in equities. The fall of the stock market thus damaged their capital position. But although the stock market crash had significant consequences for the banks and lending institutions, the principal losses were due to the collapse in the real estate market. This was due to the fact that most of the collateral was secured in flunking real estate.²¹

Zombie Firms

The collapse of the real estate and equity markets left the Japanese banks and lending institutions in a difficult situation. The collateral behind their loans had lost their value and showed no signs of recovery in the near future. On the contrary, equity prices kept falling, wiping out their recorded assets. Bankrupting their creditors would only have worsened their equity ratio, so in order to keep above water they kept on lending to insolvent firms, in order to present an idealized version of their own books. Instead of searching for alternative methods, like closing credit lines to insolvent firms, or even reorganizing the companies in question, they extended the credit period and increased facilitation. In other words, even though the companies were indeed insolvent, their loans were not written off, they were not declared bankrupt or reorganized. These insolvent companies were not only loaded with debts that would never be paid off,

²¹ Lynn Elaine Browne, "Does Japan Offer Any Lessons for the United States?" *New England Economic Review*, issue 3 (2001). <http://www.bos.frb.org/economic/neer/neer2001/neer301a.pdf> (retrieved April 27, 2010).

they were also uneconomic and impractical. That is how they came by the name of "Zombie firms".²²

One of the reasons banks wouldn't deal with their dilemma was to avoid showing lost loans on their books. Also, more often than not these loans were not extended by means of business, but through cross-share holdings and relational lending.²³

In some cases the banks kept directing capital towards insolvent, uneconomical companies. The Zombie firms, firms which had temporarily been rescued from bankruptcy but had not fully been restored, grew in numbers. American journalist Michel Schuman describes this approach in Time Magazine in this way:

*In a pathetic attempt to avoid losses, Japanese banks kept pumping fresh funds into debt-ridden, unprofitable firms to keep them afloat. These companies came to be known as zombie firms – they appeared to be living but were actually dead, too burdened by debt to do much more than live off further handouts.*²⁴

According to various economists' research, these Zombie firms had a very damaging effect on the Japanese economy and delayed its recovery. They compromised competition in the economic system and extended and deepened the economic crisis in Japan.²⁵ For example, these non-performing companies did not commit to research and development in the way other healthier companies did. That led to a set back in the development of new technologies and slowed down the overall progress of the economy. Productivity and economic growth were hindered by the inaction of the banks and lending institutions, as well as the authorities' reluctance to fulfill their supervisory role. Moreover, the Zombie firms kept other perfectly capable businesses from entering the market. These more efficient and productive businesses would in a natural economic environment have pushed the less productive, incompetent Zombies

²² Thomas F. Cooley. "Zombie Firms and Zombie Banks," *Forbes*, November 2, 2009. http://www.forbes.com/2009/02/10/recession-tarp-japan-opinions-columnists_0211_thomas_cooley.html (retrieved April 12, 2010).

²³ Nanto. *The Global Financial Crisis: Lessons from Japan's Lost Decade of the 1990's*.

²⁴ Michael Schuman, "Why Detroit is not too big to fail," *Time Magazine*, December 19, 2008. <http://www.time.com/time/business/article/0,8599,1867847,00.html>. (retrieved April 20, 2010).

²⁵ Alan G. Ahearne and Naoki Shinada, "Zombie firms and economic stagnation in Japan," *International Economics and Economic Policy*, vol. 2, issue 4 (2005): 363-381. See also: Fumio Hayashi and Edward C. Prescott, "The 1990's in Japan: A lost decade," *Review of Economic Dynamics*, volume 5, issue 1 (2002): 206-235.

aside. These productivity-decreasing companies kept healthier, better-operated companies from gaining market share although all the technical presumptions were at hand.²⁶

The insolvent Zombie firms were in fact companies that were operated on grants that at first came from the banks, but later fell on the taxpayers and clients on the market. These Zombies held the resemblance of a real company from the outside, but their infrastructures were incompetent. The damaging situation the Zombie firms created impacted the domestic market above the export companies. International Japanese companies like Toyota and others kept on as usual since they were not dependant on domestic success.. In industries where competition was the least, the Zombie firms were the most and productivity growth was the least. Because of this, smaller companies which in fact had higher productivity could not obtain any footing in the market. This created a kind of monopoly position in which giant uneconomic firms controlled the market. This consequently slowed down the productivity growth of the economic system in whole. While this charade continued, no progress was made in the revival of the economy and economic growth. As a result, the once second largest economy in the world experienced a decade long period of stagnation that would become to be known as the "Lost Decade".

While some of the blame of this incorrect reaction to the problem lay with the banks themselves, authorities bore some of the responsibility as well. The government was accountable for controlling regulation towards the banks and lending institutions and should not have tolerated their passivity. The authorities' policy included forbearance towards banks' and lending institutions' actions towards insolvent companies.

Governmental Measures

While the banking and financial sectors were feeling the heat of the situation created by the crash in real estate and equity markets, the government's message to the public was to stop saving their money and consume more. This was the complete opposite of their advice a few years back, when they urged people to save their income. The

²⁶ Alan G. Ahearne and Naoki Shinada, "Zombie firms and economic stagnation in Japan," *International Economics and Economic Policy*, vol. 2, issue 4 (2005): 363-381.

government, in turn, put even more money into building up infrastructure, thinking that investing in itself would get the wheels of the economy turning again. In the beginning of the Lost Decade the authorities seemed to underestimate the seriousness of the economic crisis they were headed into. The fact of the matter was that the crisis was triggered by the authorities themselves. That is, the Bank of Japan and their decision to raise policy rates in order to stem the appreciation of the yen towards foreign currencies. While the government was bound to realize that the tightening of monetary policy would have considerable effects on the economy they may not have foreseen the length and seriousness of the economic depression.

Monetary Policies

In the 1990s the Bank of Japan implemented a low interest rate policy, and from 1995 it actually became a complete zero interest rate. The government's initial strategy of showing patience and forbearance may have showed a composed demeanor at first. They were relaxed concerning banks' and lending institutions' inaction towards their default creditors, assured worried depositors that deposit protection would safeguard their money in the banks, provided emergency liquidity to troubled institutions, and assisted with reorganization and merging of botched businesses. In their mind they were doing theirs to keep the economy afloat and keeping their faces. They encouraged bigger banks to assist smaller, badly off banks in order to mutually sail their ship of state to shore. No major bank was to be allowed to sink, under the pretense that they were in fact too big to sink. As the banking crisis persisted it was clear that the burden of non-performing loans weighted heavily upon the banks, especially the smaller ones. To help banks stem the devastating effects of bad loans the government founded the Cooperative Credit Purchasing Company, or CCPC. The CCPC was to buy non-performing loans with collateral in real estate from the banks and lending institutions. The selling bank would extend credit for the purchase cost of the non-performing loan and the differential between the capital of the loan and the selling price could be put down as a write-off. When the CCPC had sold the indebted companies' assets the bank would be returned the credit initially extended.²⁷ These

²⁷ Nanto, *The Global Financial Crisis: Lessons from Japan's Lost Decade of the 1990's*, (2009), 5-6.

measures, however, went a short way. The non-performing loans stuck fast, burdening the banks and the economy in whole for some time to come.

With this approach of not intervening too much in the banks' and financial institutions' hardships, the government was not turning their backs towards the foresaid. They merely trusted the market to bounce back much sooner than it did. Their approach was to lend the banks a hand, but were not ready to jump all in and bailing them out yet. The banks were being kept operational and the hope was that profits from operations, and possible gains from equities, would bridge the gap created by the non-performing loans. At that time, however, the total losses created by the non-performing loans hadn't nearly been accounted for.

In 1997 the consumption tax was raised from 3% to 5% in order to try to reduce fiscal deficit.

Fiscal Policies

After the burst of the asset price bubble, Japanese authorities implemented counter-cyclical Keynesian policy. That is, government intervention for the greater good of the macro-economy, stemming the effects of a somewhat self-absorbed private sector. The government increased their public expenditures and reduced taxes, all coming to nothing. The results were only an increase in the fiscal deficit.²⁸

The Japanese government introduced total of nine fiscal stimulus packages in the 1990s, the first one being in August of 1992. In the following year two stimulus packages were introduced, another one in 1994, followed by two more in 1995. After 1993 the economy started to show signs of gradual recovery.²⁹ In 1996 there were some positive indicators to the revival of the economy, but those dreams were based on false hope. The temporary upswing in consumption and aggregate demand were temporary and could have been caused by the operations following the Great Hanshin earthquake or people's stockpiling goods in anticipation of raise in the consumption tax in 1997. Two more fiscal stimulus packages were introduced in 1998, and the last one in 1999.

²⁸ Toshihiro Ihori, Toru Nakazato and Masumi Kawade, "Japan's Fiscal Policies in the 1990's," *The World Economy*, vol. 26, issue 3 (2003): 325.

²⁹ Nanto, *The Global Financial Crisis: Lessons from Japan's Lost Decade of the 1990's*, (2009), 6.

By the latter half of the Lost Decade Japanese authorities faced a threat of another banking crisis because of the lack of real action taken in the wake of the financial crisis in the beginning of the decade. Authorities realized that they had to reconsider their policy of forbearance towards banks and depositary institutions and encouraged them to “stop throwing good money after bad”, that is, to stop spending money on a lost cause and write off default loans towards insolvent non-financial companies. In the continuance enormous sums of money were written off. But that hit the banks’ and lending institutions’ balance sheets hard. The simple fact was that the banks basically could not cope with the additional burden of writing off the non-performing loans of their creditors. The Ministry of Finance was obliged to inject capital into the failing banks. Finally, Japanese authorities seemed to be facing the facts and taking some real measures towards economic recovery. In 1998 and 1999 five major banks were declared insolvent. The Nippon Credit Bank and Long-Term Credit Bank were nationalized, but later sold to private foreign investors. Many other banks were reorganized and merged with other more capable institutions.³⁰ In 1998 and 1999 the government injected yet more capital into the banking system in order to boost their balance sheets. These capital injections added up to a 12% of the GDP in 1998.³¹

Finally, the light at the end of the tunnel was in sight. After years of struggle, the economy was gradually improving. The government’s intervention through numerous capital injections into bad-off banks, finally stepping up to their supervisory role, paid off. Laws and regulations of the financial sector were reformed, giving the authorities more leverage. It is generally believed that through a combination of monetary policy, general fiscal stimulus packages, and capital injections, the Japanese economy was on the right path. The road had been long and impassable but through real structural reform the ship of state seemed to be heading in the right direction.

³⁰ Frances McCall Rosenbluth and Michael Thies, “The Electoral Foundations of Japan’s Banking Regulation,” *Policy Studies Journal*, Vol. 29, issue 1 (2001): 23-37. <http://www3.interscience.wiley.com/cgi-bin/fulltext/119021175/PDFSTART> (retrieved April 15, 2010).

³¹ Nanto, *The global Financial Crisis: Lessons from Japan’s Lost Decade of the 1990’s*, 7.

Estimating the Costs

It is estimated that the Lost Decade cost the Japanese economy more than 20% of its GDP in that time. It needs to be considered that the losses in regard to lost opportunity and would-have profits may never been accounted for. The fiscal stimulus packages and the capital injections into the banking system alone are quite fancy. Those amounts do not account for the full losses made by the non-performing loans of Zombie firms. The bank bailouts came not only in form of direct capital injections, but also in the forms of grants, asset purchasing and loans, not to mention assistance in merging and reconstructing of failing institutions. As mentioned before, some of these contributions were later paid back by the institutions in question.

The Deposit Insurance Corporation of Japan, or DICJ, assists troubled institutions along with trying to prevent them from going under. By 2007 the DICJ had spent an amount of 46.8 trillion yen in assistance to banks and financial institutions. Direct grants were a total of nearly 40% of that sum, not to be paid back by the acceptors. Some of that amount was repaid by taxpayer funds. The total amount provided to purchasing of assets was almost 10 trillion yen, of which the larger part was later recovered. These purchase of assets included the purchased assets from bankrupt institutions and bond shares in nationalized banks. The direct capital injections spread through a total of five bailout packages amounted to roughly a quarter of the aggregated amount the DICJ spent on assisting banks and financial institutions. Some 70 % of that amount was later paid back, in some form or another, e.g. in preferred- and common shares or subordinated loans. A total of 25 banks received direct capital injections from the DICJ through the five rescue packages, the last one being in 2003.³²

National Debt

In the long period of economic stagnation, the national debt increased tremendously. In the beginning of the Lost Decade, the total amount of Japanese governmental debt amounted to 47% of GDP. In 1995 this indebtedness was up to 65% of the country's production. By 2000 national debt surpassed the GDP by 6%. The debt load only got

³² Deposit Insurance Corporation of Japan, *Annual Reoport 2006* (Tokyo: DICJ, 2007), 70.
http://www.dic.go.jp/english/e_annual/e_annual_fy2006.pdf (retrieved April 18, 2010)

worse over time, becoming a staggering 167% of Japan's GDP in 2008³³. (OECD estimates Japan's public debt to be at 172% of GDP in 2008. That is the highest of any OECD country.) In comparison the U.S. national debt is estimated at around 70% of GDP in 2008, Iceland at 96% (up from 24% in 2007) and Sweden at 47%.³⁴

The ailing of a permanently ill economy is costly and continues to burden even after recovery is obtained. Although the national debt increased considerably in the 1990s it has done nothing but kept on increasing through simple interest since then. So even with the economy doing better and the GDP up to reasonable figures, debt continues to increase both in real value and as a percentage of GDP. As of December 31, 2009 the outstanding debts of the Japanese government is the total of roughly 870 trillion yen.³⁵

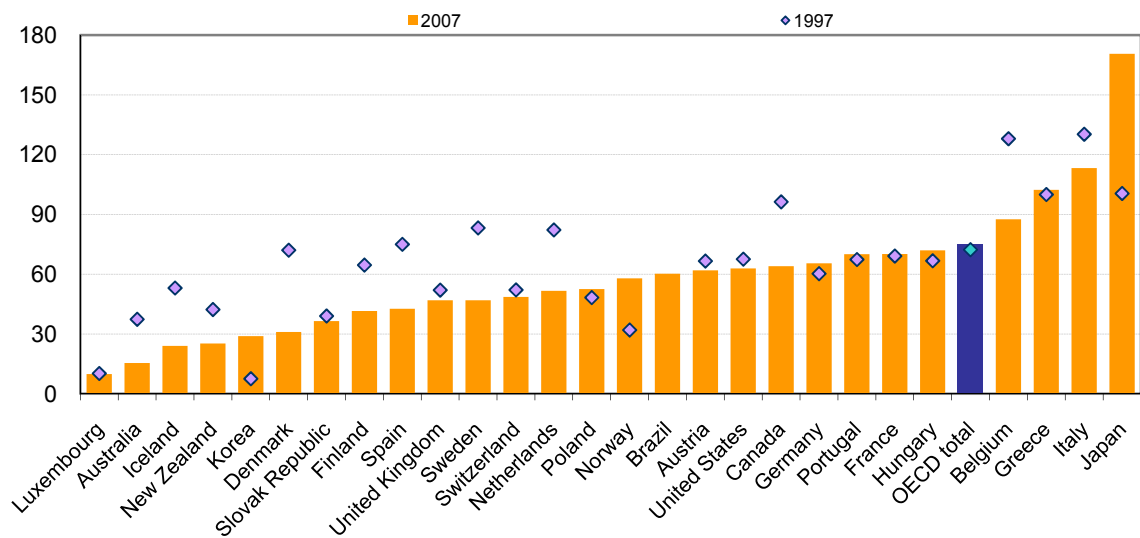
Figure 2 shows clearly how Japan is one of the most heavily indebted countries in the world at this time. Although this graph shows figures from 2007 it is interesting to see how much Japan's national debt has increased in proportion to GDP since 1997. However, it must be considered that some countries scoring lower than Japan as to national debt in 2007, have since elevated their national debt, the most obvious candidates being Iceland and Greece.

³³ Nanto, *The Global Financial Crisis: Lessons from Japan's Lost Decade of the 1990s*, 1.

³⁴ OECD Economics department, Economic Outlook, Modelling and statistical analysis, "Annex Table 32" <http://www.oecd.org/dataoecd/5/51/2483816.xls> (retrieved May 8, 2010).

³⁵ Ministry of Finance of Japan, Statistics, "Central Government Debt." <http://www.mof.go.jp/english/gbb/e2112.htm>. (retrieved April 30, 2010).

Figure 2 – Government gross financial liabilities as a percentage of GDP³⁶



Public opinion in Japan towards the government, and the role it should have, seems to have changed due to the Lost Decade and its results. While it may be that in the short run, during a crisis, governmental intervention is excusable, the opposition towards a strong government seems to be increasing. This may be due to Japanese authorities' huge debt accumulation during and after the Lost Decade. It seems that further expanding the governments' participation in the business community could, in fact, result in the bankruptcy of the Japanese government.³⁷

Criticism on Japanese Authorities

While it is clear that the economic recession in Japan in the 1990s was due to the asset price bubble burst, there are those, that believe that by 1995 the economy should have already been back on track after suffering from the crash of the real estate and equity markets. It is argued that the extended period of recession in the latter half of the Lost Decade was due to the authorities' initial mistakes in fiscal and monetary policies. In fact, the problems caused by the asset price bubble burst were small compared to the damage done by the authorities themselves. By their preliminary

³⁶ OECD Stat Extracts, "Country statistical profiles 2009: Japan."
<http://dx.doi.org/10.1787/537825212141>. (retrieved May 7, 2010).

³⁷ Ihori et al., "Japan's Fiscal Policies in the 1990s.", 336-337.

inaction, and let down in their supervisory policies they struck an already weakened economy a heavy blow.³⁸

Others claim that the problem causing the length and depth of the recession was not the government's mistakes in its monetary or fiscal policies, nor was it due to a structural failure, but rather that it was due to a so called "balance sheet recession". That is, when households and companies find themselves having less capital for consumption, they cut back on investment in order to re-place their distorted balance sheets. Businesses tend to focus on decreasing their debt instead of increasing their profits and private households hold tighter on to their hard-earned money. Instead of trying to get companies and individuals to up their consumption by pumping fresh funds into the banks, authorities should rather pursue a policy of purchasing debts from bad off companies and individuals.³⁹

While the government continually kept pumping fresh funds into the market, individuals as well as businesses sat back. This is in accordance with the Richardian equivalence theorem. That is, when the citizens anticipate a rise in national debt, they put their money aside because they rightfully assume that what is borrowed today has to be repaid in the future.⁴⁰ In this way individuals can unravel government policies intended to stimulate investment and economic stability. When the authorities keep pumping capital into the market it seems like a desperate attempt to get the wheels of economy turning again. That indulges cynicism towards the economic system. If the authorities themselves do not seem to trust in the capability of the economy well enough to let it sustain itself, then why should the individuals? This lack of trust can be persistent and does not completely wear off until people truly believe that the economy has hit rock bottom.

As Japanese authorities found themselves having overcome the deflationary spiral of the nineties, they faced another serious economic condition, the difficult predicament of stagflation. That is, prolonged economic stagnation caused by the authorities' policies which were meant to assist the economy and stem inflation, but instead

³⁸ Takatoshi Ito, "Retrospective on the Bubble Period and Its Relationship to Developments in the 1990's" *The World Economy*, vol 26, no. 3 (March 2003): 298-299.

³⁹ Koo, *The Holy Grail of Macroeconomics: Lessons from Japan's Great Recession*.

⁴⁰ Economy Professor, Theories, "Richardian equivalence theorem," <http://www.economyprofessor.com/economictheories/ricardian-equivalence-theorem.php> (retrieved May 8, 2010).

contributed to the economic stagnation. Action taken to overcome the economic stagnation, pumping fresh funds into the market to increase investment, would result in ascending inflation. It has been argued that by increasing money supply, monetary authorities can contribute to inflation, and the government can in turn deepen the economic stagnation by increasing intervention and regulation in the market.⁴¹ This type of stagflation has proven to be very complex in handling and very expensive and difficult to dispose of.

Japan in the 21st Century

Even with the economy slowly starting to recuperate in the new millennium, Japan is far from the economic power it once was. While Japan had a hard time recovering from its economic crisis in the 1990s other Asian countries, such as South Korea and Taiwan, seemed to manage their own economic crisis in a far better way. One of the problems Japan is facing is their rapidly aging population. Furthermore, Japanese products have been becoming less and less competitive internationally. The technical advantage Japanese products, especially in the high-tech industry, used to have, is disappearing, giving way to other countries like India and China.

While some seem optimistic that Japan will rise from the ashes, becoming the super-economy it once was,⁴² others seem less sure. The economy did certainly improve after the turn of the century, but at the same time the world economy was in an upswing as a whole. It has showed that after the world economy crash in 2008 Japan's situation has worsened yet again.

Although some structural reforms were made in Japan that certainly improved their situation, the honor should not entirely be ascribed to Japan itself. Japan's neighbor, China, has been getting its second wind lately. The upswing in Japanese economy is somewhat due to the increase in Chinese investment in Japan. A good part of Japan's exports now go to China instead of overseas like it did in the eighties. Japanese

⁴¹ Oliver Jean Blanchard, *Macroeconomics*, 2nd ed. (Upper Saddle River, N.J.: Pearson Prentice Hall, 2000), 172-173 and 434-436.

⁴² Richard Katz, *Japanese Phoenix: The Long Road to Economic Revival*, (Armonk, N.Y.: M.E. Sharpe, 2003), 3-4.

products have lost their edge, maybe due to the stagnation of innovation in the 1990s. Countries like South Korea and India, that had been at the back of the line for some time, forged ahead.

A society like Japan, which has reached full expansion, needs one of two things in order to progress: either some form of a new groundbreaking technology that increases efficiency, or population growth. As population growth rate is at a -0.191% in Japan⁴³ the population is rapidly aging. The technological edge the Japanese used to have is vanishing while overseas technical development is escalating with groundbreaking inventions, e.g. in the computer sector. Furthermore, shortage of land troubles the Japanese' options, giving way to vast countries like China and India that have an increasing growth rate as well as land space.

One sector where Japan could find their drive is exploring their untapped resources on the market. For example gender equality is not as far along in Japan as in other countries, leaving a majority of the population, the women, at home instead of utilizing their efforts on the employment market.

Lessons to be Learned for Iceland

20 years after the collapse of the Japanese economy, another island nation almost 9.000 kilometers away faced very similar situation as the Japanese had in the early 1990s. Iceland, although a much smaller nation with an economic system only a fragment of that of Japan's, faced a situation in which their over-inflated economy finally. All of the local privately held banks went bankrupt and were nationalized. While some blamed the 2008 world financial crisis, most acknowledged that the reasons for the Icelandic financial crisis was to be found much closer to home. Real estate prices had escalated in the years leading up to the economic collapse, and Icelandic companies had been expanding internationally, causing elevation in the stock markets as well. The smallness of the Icelandic community had lead to relational lending similar to that of the government–private sector relation in Japan. Cross share holdings through several Icelandic companies, both in the financial and non-financial

⁴³ C.I.A., Publications, "The World Factbook," Japan. <https://www.cia.gov/library/publications/the-world-factbook/geos/ja.html> (retrieved April 30, 2010).

sector, disturbed professional business methods and loans were distributed through unprincipled means.

The biggest difference in the case of Iceland from Japan is that the Japanese economic crisis mainly injured banks and financial corporations as well as non-financial companies. In Iceland the collapse of the overly inflated markets, especially the real estate market and the plummeting value of the local currency, affected the public as well as the banks and other businesses.

In the wake of Iceland's asset price bubble burst, much of the blame was pinned on neo-liberalism. The liberal and conservative political parties were imputed, and middle-left and left wing parties took the reins of government. Their first immediate action was to raise taxes and tighten monetary policies. Their approach is, in many ways, similar to the ones taken by Japan with the implementation of the counter-cyclical Keynesian policy. While the intentions may be good, the speed of structural reform seems to be rather slow. In order to reform public spending and taxation more efficiently, further efforts are needed. Ihori et al. maintain that "the most important policy lesson from [Japan's] fiscal policy in the 1990s is that long-run structural reform is more important than short-run Keynesian policy."⁴⁴ In other words, while it may well be that a state led market economy is useful in the recession's darkest day, when it comes to the restoration of the economy, it is best served by free market competition. Another important lesson from Japan is that it is crucial to build up trust in the long term policy and the viability of the economy.

Face Up to the Challenge

One of the first and biggest mistakes the Japanese government made in the wake of its economic collapse was the reluctance to admit to its seriousness. Their impression was that this problem would somehow resolve itself by means of economy. They figured by keeping economic growth slow but steady and policy rates low they could rid themselves of this crisis, increasing productivity and banking profits. Their slow reaction was for the most part due to their own entanglement in the matrix of cross relational lending and coinsurance.

⁴⁴ Ihori et al., "Japan's Fiscal Policies in the 1990s.", 337.

Furthermore, the Japanese government made mistakes in their monetary- and fiscal policies. When the economy finally started leveling off, their policies had to be even harder than if they had dealt with their problems properly right away.

While a recession is inevitable after an over inflated market bubble bursts, the actions in the wake of the burst are crucial. Taking the right actions can affect the recession's significance and the course of direction the economy will fall into afterwards.⁴⁵

The Japanese have tried to calculate their losses of the Lost Decade to some extent. But it is impossible to evaluate the losses created by loss of growth and lost opportunity.

Revolt the Infrastructure of a Rotten System

One of the reasons for the Japanese government's reluctance at the time to really do something to revolutionize the system was that a lot of persons in authority had interests at stake in the old system. Lack of transparency in the decision making process following the economic collapse prevented the real culprits from being held responsible. Whether domestic or external, there should have been some constraints on the authorities, urging them to be more firm in their actions.⁴⁶ In other words there was a conclusive lack of political leadership. While the Icelandic authorities have certainly taken their time in appointing various committees and working parties in order to investigate the events leading up to the Icelandic financial crisis, any real action has been compact. Although a recent publication of an extensive investigative report has kindled hope that some real action will take place.

Like in Japan, there are many high-level officials in government as well as businessmen involved in questionable dealings leading regarding corruption and immorality. They seem to be somehow shielded by a protecting sphere, preventing any legal action to be taken against them. The smallness of the Icelandic community may somehow contribute to this, since it can almost be said that everybody knows everybody else. The infrastructure of the system that accommodates political corruption and viciousness must be torn down in order for a new system to root. This was too late realized in Japan, and arguably never to the full. Following the economic crisis in Japan

⁴⁵ U.S. Congress, Joint Economic Committee. *Policy Lesson from Japan's Lost Decade*.

⁴⁶ Masahiri Kawai, "Reform of the Japanese Banking System," *International Economics and Economic Policy*, vol. 2, Issue 4 (2005), 307.

there was no real payoff. None of the real culprits were held responsible for their actions, and they most likely still sit in their offices in a sky scraper somewhere in Tokyo. The chances are the same things will happen in Iceland if nothing further is done.

Get Rid of Insolvent Companies

In Japan the magnitude of non-performing loans was heavily underestimated. Banks, reluctant to show losses of loans in their books, kept granting loans into insolvent companies. In doing this they weren't ridding themselves of the problems at hand, only postponing the consequences. Had they only admitted their losses, and let their debtors file for bankruptcy, they would have made way for new competitive companies to come forth. Surely they would have suffered some losses at first, but with help from the government they could have kept afloat and in time actuated incorrupt market competition. Even though banks and lending institutions would indeed not get the original value of their debtor's assets they certainly would get some part of their debts back. The process of counting their losses would not have been without pain, but necessary nonetheless. This could have been done through some form of regulation, requiring banks and lending institutions to report on their debtors' real financial situations and for the government to have followed through on their regulations. In not doing so, the banks and lending institutions instrumentally suffered losses of their own, gradually having to receive government aid in form of increased capital or otherwise. When the severity of the situation that the non-performing Zombie firms created was finally dealt with, the losses were up to much bigger amounts than they had to be, had the problem been tackled right in the beginning.

Economic recovery was put off by the assistance of measures retarding competition and efficiency in business operations. First, when the situation was dealt with by decidedness and pragmatism, that is by writing off non performing loans and reorganizing insolvent companies, gradual economic recovery occurred. One of the lessons that can be learned from Japan's mistake of not dealing with insolvent

companies right away is, that it is urgent to take action to secure that indebted but operational companies be saved but the impractical ones be thrown aside.⁴⁷

In Iceland, concerns have been voiced that outsiders will abuse Iceland's situation by buying companies' assets below value. The insolvent bank's estates stubbornly try to stem their properties from going on a fire sale, refusing to sell anything remotely under their asking price. It has also showed that the Icelandic banks' resolution committees are reluctant to write off their insolvent creditor's loans in fear of lessening their market value and equity. The Icelandic market is currently dealing with overpriced, unserviceable companies with mountains of non-performing loans.⁴⁸ These worthless companies have even been mortgaged onwards for loans of their own, that of course shall never be paid back. And people wonder why no one seems remotely interested in such a bargain. In order for the economy to recuperate, this sentiment has to stop. For someone to buy the companies they first must be made marketable. No one is going to buy a company with heaps of outstanding loans in worthless businesses, their properties only coming up to a fraction of their liabilities. The non-performing already lost loans need to be written off. Even if it would, and it most definitely will, lessen the market value of the company. The insolvent companies would perhaps serve better if they were to be put into liquidation and not kept alive only on paper, becoming a burden on the economy, slowing its recovery. The banks and financial-corporations must reevaluate their assets in regard to the losses of their non-performing loans. If the financial crisis in Japan holds any lessons for Icelanders it is that waiting and hoping that the economy will magically return to its former state, the wait will be long and possibly harmful for the business environment. Forbes columnist and professor of Economics, Thomas F. Cooley, finds that despite the obvious injustice in the government bailing out companies run to the mud by discreditable characters, then so be it. Maybe the Icelandic have to take Cooley's advice and "[t]ake the medicine, feel the pain and put a stake through the heart of the zombies. Then [...] get back to work."⁴⁹

⁴⁷ Kobayashi, "Financial crisis management: Lessons from Japan's failure."

⁴⁸ Thorvaldur Gylfason, "Events in Iceland: Skating on thin ice?" *VoxEU*, April 7, 2008. <http://www.voxeu.org/index.php?q=node/1033> (Retrieved May 8, 2010).

⁴⁹ Cooley, "Zombie Firms and Zombie Banks."

Conclusions

It is clear, looking towards Japan's experience of a financial crisis lasting at least a decade, arguably for two, that an economy as small as Iceland cannot survive stagnation that long. Instead of taking immediate action and dealing with the issues at hand, Japanese policymakers seemed to be in denial, refusing to face up to the dilemma at hand. Whether this prolonged state of denial was due to some cultural characteristics of the Japanese or the reason being the closely knit relationship between the government and the private sector is hard to say. Perhaps it was a combination of both. When, in due time, the authorities were forced to own up to their initial mistake of inaction, they were very halting in their actions. Unfortunately, there are indications that the same mistake of inaction is being made in Iceland. Although the events leading up to the Icelandic financial crisis in 2008 may not be the same as in Japan in the early nineties, there are some things to be learned from Japan's mistakes.

The general perceived reasons for the extended period of stagnation in Japan are threefold. The first mistake was the authorities' reluctance to admit their real problems; there was no real will to revolutionize the system that initially caused the economic crash. This extended period of inaction was largely due to the closely knit relationship between politics and the private sector. Secondly, mistakes were made in monetary- and fiscal policies in the 1990s. And finally, the government accommodated banks' and lending institutions' forbearance towards non-performing zombie firms. The losses created in the last mistake, ended up on the government's balance sheet, that is the taxpayers. These mistakes in aggregate have mired one of the greatest economies in the world in a deflationary depression for two decades. Moreover they have saddled generations to come with debts they didn't contribute to and shouldn't be held responsible for.

There is no reason for Iceland to re-invent the wheel since there are predecessors to Iceland's situation. The experiences of the Japanese' can be used to evaluate the best next steps for Iceland. Forbearance and inaction are clearly not the way to go, unless Iceland wants to spend decades throwing good money after bad. In the end,

authorities need to face the facts, draw from the Japanese' experiences and reform the system from its core, not just rattle it softly. Non-performing loans create overvaluation of companies if they are not written off. In order to show the real values of companies, unserviceable companies should perhaps be allowed to fail in order for free market competition to revitalize the economy and build up trust in it anew.

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