*Japan’s Long, Lost Decades*

A Historical Assessment of Japan’s Unnecessary Economic Slump

Eric Peterman

ECON 420

12/10/14

 Dr. Herbener

***Introduction***

In an article written on October 30th, 2014 for *The New York Times*, American economist Paul Krugman strongly criticized American policymakers’ inadequate response to the economic crash in 2008. Krugman referenced prior criticism made by him and Ben Bernanke towards Japan’s response to their own economic crisis in the 1990’s[[1]](#footnote-1) and noted that “in some ways they look more relevant than ever now that much of the West has fallen into a prolonged slump very similar to Japan’s experience.” He later proclaimed that “Japan used to be a cautionary tale, but the rest of us have messed up so badly that it almost looks like a role model instead.” So what happened in Japan that notable American economists want to prevent in their own nation’s economy?

 Many have classified the years following 1989 as the Japanese economy’s “lost decades.” Gross domestic product (GDP) growth was slow and prices were in decline. The goal of this paper is to explain the causes and the nature of this period, roughly through the early 2000’s. Though policy conclusions may be drawn from the analysis in this paper, the arguments will mostly be historical. The focus will be less on the boom and the collapse per se, but more on the question of why the collapse lasted so long. The answer to this question has more important implications for the Japanese economy and its relevance to America’s own economic crisis.

 There are a variety of answers to this question among economists. Both Krugman and Bernanke believe that Japan was in a liquidity trap during the 1990’s; traditional policies could not lift Japan out of the recession. Of course, they fail to adequately explain what caused the recession in the first place. Other economists, like Kuttner and Posen, argue that Japan did not escape the recession because fiscal policy was not nearly expansionary enough. Richard Koo’s position is that Japan was in a balance-sheet recession where firms could not lend because they had to pay off their debts. This reduced GDP growth. Hayashi and Prescott argue that Japanese banks were fully capable of lending; but they did not because productivity was low. Hoshi and Kashyap are two economists who place much of the blame on a broken banking system.

 The point of a historical essay may be to objectively “get the facts straight,” but all historical analysis is framed by the author’s assumptions. In this paper, the historical case of the Japanese lost decades will be analyzed within the framework of the Austrian business cycle theory put forth most famously by Ludwig von Mises, Friedrich Hayek, and Murray Rothbard. The basic tenets of this theory are that business cycles begin when central banks inflate the money supply and expand credit. This pushes interest rates lower than the pure time preference rate of interest. As a result, resources shift towards the higher stages of production and asset prices increase. Eventually, whether through monetary contraction or otherwise, time preferences will set in and interest rates will return to normal. During the bust, entrepreneurial errors are corrected and capital is consumed.[[2]](#footnote-2)

In general, I assume that extensive government interference with the free market will always inhibit this readjustment process and natural economic growth. In order to fully understand the Japanese economic contraction, the preceding boom must also be explained and stagnation must be viewed in light of government manipulations of the free market. None of the literature described above takes full account of the boom and bust cycle and the way that government mechanisms continue this cycle. In my paper, I seek to base my analysis on sound theory which other economists ignore.

 I have found that monetary inflation and credit expansion between 1987 and 1989 caused a boom characterized by increasing stock and asset prices. As a result of lower interest rates, capital was mal-invested. However, the Bank of Japan abruptly increased interest rates in 1989 and brought on the bust. This deflated stock and asset prices, but monetary contraction and bankruptcies continued. Unfortunately, the economy did not fully correct and the Japanese government engaged in intense monetary inflation, fiscal expansion, and tax increases. The inefficient nature of the Japanese economy, marked with cartelization and “zombie firms” spurred on by a broken financial system, prevented the market from asserting itself and fixing entrepreneurial errors. This has caused Japan to remain in a consistent state of stagnation marked by real economic losses and capital consumption.

 This paper will begin with an examination of the boom and its causes. I will then look chronologically at how the boom ended and the bust began. The bulk of the paper will be my evaluation of what caused the bust to extend so long. I will address government efforts to inflate the money supply, higher fiscal spending and taxes, the broken financial system, and the statist nature of the Japanese economy. In the end, I assess claims that Japan did not really have any lost decades.

***The Boom and Its Causes***

The bust in 1989 did not come out of nowhere. A period of heightened economic growth and optimism, perhaps even a “golden age,” preceded the economic contraction. However, this growth would later be revealed to be a bubble stoked by enormous increases in the money supply. Why did the Bank of Japan pursue such expansionary policies? Though there are a variety of explanations[[3]](#footnote-3), the most significant is that movements in the international exchange markets encouraged the Bank of Japan to act in this way.

 Ever since the collapse of the Bretton-Woods system in 1973, the international system of floating exchange rates has encouraged competition between different currencies. Various nations try to make their own currency dominant to reap supposed economic benefits. In East Asia, the Japanese Yen has been less widely used than the American dollar. The Yen is stronger as a store of value than a medium of exchange. During the 1980’s Japanese economists and policymakers called for a more internationalized Yen to promote Japanese products. To do so, the Japanese financial system was partially deregulated and offshore Japanese financial markets were established during this time. Many continue to push for a more internationalized Yen (Ogawa 2000, pp. 1-29). Thus, there was great pressure to guarantee a stable value of the Yen during the 1980’s to achieve greater international demand.

 While Japanese politicians were concerned about the value of their own currency, significant developments occurred in currency markets around the globe to encourage monetary inflation in Japan. The early 1980’s was marked by a heavily appreciating dollar. Many economists feared that the United States would be unable to pay down its debts from importing so much (Grimes 2001, pp. 110-1). As a result, the Plaza Accord was made among five advanced economies to decrease the value of the dollar and increase the value of other currencies, including the Yen. Originally supportive of the agreement, the Bank of Japan increased interest rates to bring the Yen’s value up. These cooperative policies were successful: the dollar collapsed and the Yen soared (Grimes 2001, pp. 113-6).

However, fears grew in Japan that an *endaka[[4]](#footnote-4)* recession would result due to reduced exports. In response to this threat, the Bank of Japan decreased the discount rate in January of 1986 and the rate cuts continued through the end of the year. But, the Yen continued to rise and the dollar to fall (Grimes 2001, pp. 116-22). Less than two years after the Plaza Accord, the Louvre Accord was signed to coordinate policies so that the international currency markets would stabilize where they were, which they mostly did. But, the Bank of Japan kept their target interest rates at 2.5% for the next two years (Grimes 2001, pp. 122-4). International policy coordination essentially had the effect of moral hazard on Japanese officials. Since the international community was given the responsibility to ensure currency market stability, Japan was enabled to inflate their money supply as much as they wanted to. International currency manipulations tend to promote monetary inflation.

And Japan sure did inflate. As a result of the Bank of Japan’s policies, the M2 money supply increased by a rate of over 10% per year between 1987 and 1990. As we have already seen, the discount rate fell from 5% to 2.5% between January of 1986 and February of 1987 (Grimes 2001, pp. 138-9). All of the official announcements about the rate cuts by the Bank of Japan reveal that they were concerned about trade imbalances and international currency fluctuations and their effects on domestic demand (Okia, et. al. 2001, p. 421). In addition to current account concerns, the Bank of Japan was further encouraged to keep rates low due to the fact that consumer price inflation was less than 1% in 1986, 1987, and 1988 (Grimes 2001, pp. 141-2). The Bank of Japan believed that growth was high and inflation low, so there was no apparent reason to end the monetary inflation.

Though there may have been little or no consumer price inflation, asset prices exploded during the late 1980’s in Japan. Regular increases in the money supply enabled banks to increase lending by lowering interest rates below the level that social time preferences had dictated. Lower interest rates encouraged increased investment into higher stage capital goods. Thus, the Nikkei 225 peaked close to 40,000 in 1989, over three times the level of 12,500 in 1985. The total valuation of first tier stocks on the Tokyo Stock Exchange (TSE) increased from ¥169 trillion in 1985 to ¥527 trillion in 1989. The newly earned high incomes of the owners of higher stage capital goods also led to an increase in the value of factors of production. Though real estate prices are hard to quantify, best estimates reveal that they increased three-fold between 1985 and 1991. Revealingly, they rose most dramatically in Tokyo, demonstrating that the new money was first circulated in the capital city (Grimes 2001, pp. 139-41). Economist Doug French best explains the monetary inflation.

At the bubble's height, the capitalized value of the Tokyo Stock Exchange stood at 42 percent of the entire world's stock-market value and Japanese real estate accounted for half the value of all land on earth, while only representing less than 3 percent of the total area. In 1989 all of Japan's real estate was valued at US$24 trillion which was four times the value of all real estate in the United States, despite Japan having just half the population and 60 percent of US GDP. (2012)

Thus, concerns over foreign exchange interventions caused the Bank of Japan to

embark on a period of intense monetary inflation. This caused enormous and unsustainable asset price increases. Prices were distorted so that entrepreneurs under-estimated social time preferences, resulting in mal-investments. This boom period would last as long as the Bank of Japan continued to inflate and true time preferences remained hidden.

***The Collapse***

Monetary inflation continued unabated in the beginning of 1989, but the Bank of Japan started to feel pressure to end it as the first signs of general price inflation arrived. In 1989, the consumer price index (CPI) increased by 2.3% (World Bank). Beginning in May of 1989, the Bank of Japan started to increase its discount rate. The rate was increased sharply until August 1990 when it reached a peak of 6% (Grimes 2001, 141-2). Some have criticized the rapidity with which the central bank increased its discount rate by noting that the rate dropped even while the stock market was already collapsing. The economy essentially hit a brick wall (Bernanke 2000, pp. 3-4). However, many Japanese at the time, including Japanese business associations know as *keidanren*, were quite pleased with the actions of the Bank of Japan. They saw the resulting asset price declines as necessary to an improving economy (Fletcher 2012, pp. 21-2). In fact, confidence was high and GDP grew at a rate of 5.6% in 1990 (Grimes 2001, p. 143).

Regardless of how the rate hikes should have occurred, they did and they caused asset prices to fall dramatically. The Nikkei 225 fell to 20,221 by October 1990; nearly half of where it was at its peak. The onset of real estate price deflation was quite a bit slower as it did not start until 1992. Land prices declined slowly but steadily throughout the 1990’s (Grimes 2001, p. 145). The money supply continued to grow at rates higher than 5% until 1992, when it dropped to near-zero. The quick rate hikes allowed interest rates to move closer to the level of time preferences. As a result, asset prices and stock prices moved to more reasonable, market-determined levels. The unemployment rate remained below 3% until 1995 and real GDP per capita increased at typical levels through 1995. However, real GDP growth floundered below 1% starting in 1992 as capital was consumed (World Bank).

The discount rate hikes mostly ended the monetary inflation and credit expansion of the late 1980’s and brought the Japanese economy more in line with the preferences of consumers. Though this correction process should theoretically have been relatively quick, each historical case of an economic bust varies with each county. Much of this variance can be attributed to the degree to which a country’s government pursues *laissez-faire­* policies in the wake of a bust. Busts will be quicker if the state lets the market work things out without interference. But they will be longer if the state chooses to intervene and relieve some of the pain of the bust (Rothbard 2000, pp. 19-23). The latter has certainly been true of Japan. Long-term stagnation has resulted.

***Monetary Policy***

Though the falling asset prices concerned the Japanese government, this alone was not responsible for its aggressive response. The end of the inflated real estate prices brought great stress upon the financial system. Those who borrowed money in the late 1980’s to purchase assets which values were now in decline had little incentive to continue servicing those debts. The fact that land was often used as collateral further contributed to financial instability (Grimes 2001, pp. 145-6).

Beginning in 1990, there were sporadic financial failings. In 1994, two significant deposit-taking institutions, Tokyo Kwoya and Anzen, failed. The Japanese government protected the deposits at these institutions (Nakaso 2001, pp. 3-4). Also, non-bank housing loan corporations known as *jusen* benefited immensely from the housing boom and newly established regulations on banks during the 1980’s. After the crash, the Ministry of Finance revealed in 1995 that 76% of jusen loans were nonperforming and 60% were unrecoverable. Though jusen are technically not banks, the majority were owned by banks. Thus, banks also felt great stress (Grimes 2001, pp. 146-7). In 1995, seven jusen companies failed with losses of over ¥6 trillion that were partially covered by the tax payers. Voters found this to be outrageous (Nakaso 2001, p. 6). The Bank of Japan felt that it was necessary to prevent this disaster from spreading.

 Monetary authorities in Japan during the 1990’s relentlessly tried to inflate the money supply. To boost bank reserves, the discount rate was unconventionally lowered from 6% starting in late 1991. By 1995, the discount rate was 0.5% and the reserve ratio requirement was reduced by 40%. The rate has remained near zero to the present day and a program of quantitative easing began in 2001 (MacLean 2006, pp. 94-7). Japanese officials hoped to give stability to a banking system burdened by bad debt and to keep prices at a moderately inflationary level to prevent debt deflation. Many have argued that until 1995, the Bank of Japan was far too afraid of inflation and was not nearly aggressive enough. In general, they argue that Japan’s central bank has been far too conservative (Bernanke 2000, pp. 3-4 and MacLean 2006, pp. 90-94). Regardless of how intense the monetary policy was, there is no doubt that officials were looking to expand the money supply and not contract it.

 Did it work? Looking at trends in the money supply, M2 money supply growth remained below 5% between 1992 and 2001. It contracted slightly in 1993 (World Bank). Though the monetary based expanded by over 25% between 1994 and 1997, the M2 money supply increased by only 10% and bank credit by less than 1% . Krugman uses these statistics to push for unconventional monetary policy to increase bank credit (1999, pp. 174-6). The CPI fell below 3% in 1992, remained there, and occasionally dipped into deflationary territory. Real GDP growth did not rise above 3% for the remainder of the decade (World Bank).

 As the decade continued, financial problems worsened. A number of major financial institutions failed in 1997, namely Nippon Credit Bank and Hokkaido Takushoku. In November of 1997, financial institutions failed on a weekly basis (Nakaso 2001, pp. 7-8 and Lincoln and Friedman 1998, p. 365). Japan entered a deeper recession and GDP fell for the next two years (World Bank).[[5]](#footnote-5) In response, the Bank of Japan continued to inject liquidity into the system with interest rates close to zero. A bank bailout plan crafted by the Ministry of Finance was passed in 1998 that covered ¥30 of these financial losses (Lincoln and Friedman 1998, p. 365). The continued instability of the financial sector held GDP down. During the 1980’s, real GDP growth averaged at 3.9%. Between 1991 and 2002, it averaged at 1.3% (MacLean 2006, pp. 86-7). Unemployment, though low by American standards, reached new highs above 4% by 1998. What happened to the new bank reserves that were supposed to generate growth?

 Evidence reveals that Japanese banks have been holding onto excess reserves. Bank failings prompted surviving banks to hold onto their reserves and not lend out as much as they could by law. Extremely low interest rates and the presence of numerous bad loans and assets forced many banks to hedge against the prospect of further instability (Ogawa 2007, pp. 10-11). Beginning around 1995, the standard deviation of the ratio of actual reserves to required reserves increased far above one, revealing that at least some banks were holding onto their cash. In 1997, there were three times as many reserves in the banking system as necessary. When quantitative easing began in 2001, it was nearly five times above the required level; similar to the American experience since the 2008 crash (Ogawa 2007, p. 3).

 There are further are that Japanese bank lending was less than stellar. Looking at the size of the Bank of Japan’s balance sheet, it is obvious that monetary expansion was intense: it increased from around ¥50 trillion in 1995 to ¥130 trillion in 2002. The Bank of Japan bought assets from commercial banks to increase bank reserves (Iwata and Takenaka 2012, p. 4). Some have suggested that the lower interest rates set by the central bank resulted in a carry trade where foreigners would buy Yen in Japan cheap and sell them elsewhere to earn a profit. Instead of boosting Japanese growth, monetary inflation supposedly increased international economic growth. Some have even argued that low interest rates in Japan fueled the American housing crisis that began in 2007 (Hattori and Shin 2009). These points deserve a more thorough analysis from economists who believe in the Austrian business cycle theory.

Thus, it is clear that the expansionary monetary policies of the Bank of Japan have increased the balance sheets of its affiliated commercial banks while only disproportionately expanding the money supply. Monetary policy has not worked to improve the Japanese economy. Many, including Paul Krugman, argue that this proves that Japan is in a liquidity trap and that only unconventional monetary policy or fiscal policy can relieve Japan of its problems. Specifically, Krugman supported inflation targeting at 4% for the next fifteen years to improve the credibility of the Bank of Japan (1999, pp. 179-81).

However, Japan’s predicament was that its banking system was one part of a statist system that did not allow poor investments and loans to be liquidated. Faced with continuing monetary injections, banks were not allowed to eliminate the bad debts that they were holding but only hedged against them. Even if the banking system had successfully re-inflated, this would only have created another bubble to be burst with unemployment and bankruptcy. Before addressing the financial system any further, I will briefly consider the Japanese government’s other main macroeconomic policy tool.

***Fiscal Policy***

The other tool which politicians use to stabilize the economy during a recession is fiscal policy. Though most economists unequivocally believe that expansionary fiscal policy is helpful during a recession, reality is more complicated. It is true that lower taxes are beneficial. Entrepreneurs and consumers are allowed to hold onto more of their wealth and spend it in ways that satisfy preferences. When the state takes more taxes, it prevents citizens from meeting their desired ends. On the other hand, increased government spending is harmful to the economy. Stimulus may boost GDP statistics, but it takes productive resources and uses them in production lines dictated bureaucratically, not based on profitability. Thus, it is harmful to the efficient market economy.[[6]](#footnote-6) The creation of debt through fiscal stimulus is also damaging to the economy for it is either funded through taxing more wealth, crowding out private borrowers, or inflating the money supply. If the government reduces taxes, it is also preferable to lower government spending to prevent the growth of debt and the possibility of higher taxes in the future Increased government spending ruins an economy’s ability to recover from a recession.

 Fiscal policy during the 1990’s in Japan was certainly damaging towards the economy. Between 1992 and 1995 alone, fiscal stimulus packages amounted to about ¥50 trillion (Lincoln and Friedman 1998, pp. 362-3). Fiscal stimulus in 1995 forced the Ministry of Finance to borrow ¥22 trillion. In 1996 and 1997, the debt grew so high that debt servicing increased to one fifth of the budget (Ihori, et. al. 2001, p. 60). Pressure grew to reduce the debt and in 1997, the Fiscal Structural Reform Act was passed. Expenditures were reduced by 1.3% and the consumption tax increased from 3% to 5%. Many economists have argued that this led to the recession in 1997. However, these tax increases were rolled back and the government stimulus returned in 1998. Throughout the decade, there were several tax reductions, but they were rather modest (Kuttner and Posen 2001, pp. 128-9). Increased government spending and taxes did not allow the Japanese economy to properly recover during the 1990’s.

 Others, including Kuttner and Posen, argue that the fiscal stimulus was not strong enough in Japan. They say that the debt has ballooned in Japan not because government expenditures have been too high, but because tax revenues have decreased. In fact, expenditures have actually fallen (2001, pp. 125-6). Public works stimulus packages in 1992 and 1993 only amounted to approximately 2% of GDP, which was not enough in the eyes of Kuttner and Posen. They also decry the rather minor income tax reduction in 1995 as too small compared to the consumption tax hike in 1997. The stronger fiscal packages passed in 1998 and 1999 were still not potent enough to increase aggregate demand to an appropriate level (2001, pp. 127-9). Against the Keynesian concept of “the big G,” they do believe that Japanese fiscal policy tends to be too wasteful. This should be reformed (2001, p. 129). However, government spending is by nature inefficient and cannot be reformed to be efficient.

 Other economists, like Ihori, Nakazato, and Kawade, argue that the policies were strong but ineffective. They conducted an econometric study which concluded that the fiscal stimulus failed to increase output in the economy. The government crowded out private investment through increased borrowing and was unable to stimulate private consumption (2004, pp.61-4).The economists also condemn the fiscal stimulus for increasing the public debt so much. For example, the bond dependency ratio increased from 7.6% in 1991 to 22% in 1994, showing that large amounts of new bonds were floated to fund the debt (2004, p. 59). These economists argue that the enormous growth of debt is unsustainable and has made fiscal policy nearly worthless, since it will require higher marginal tax rates to service. However, they ironically argue that taxes used to make budget deficits smaller would not be so damaging to the economy. In fact, they would be helpful because tax increases now would prevent pain later (2004, p. 66-7). Ihori, Nakazato, and Kawade want reduced spending and deficits, but they also would like higher taxes.

 In reality, Japanese growth was so miniscule in the 1990’s not because certain policies were ineffective, but because the Japanese government believed that it could resurrect the economy through these policies. Economists can make whatever claims they want to about the strength of a fiscal policy action, but there is no denying that the government spent tens of trillions of Yen acquired through taxes on projects designed to increase activity in the economy. By nature, such activity is inefficient and opposed to the profit-motive on a free market. The consumption tax increase enacted in 1997 was no doubt damaging to the economy and probably did lead to that year’s deep recession. In fact, Japanese public opinion turned towards smaller government in reaction to the outrageous tax-and-spend policies that many believed would lead to the bankruptcy of the Japanese government (Ihori, et. al. 2004, p. 70). Total central government debt increased from about 50% of GDP in 1992 to over 100% of GDP in 2000 (World Bank). The exploding debt, apart from any supposed gains from more spending, must have concerned businessmen about the future of their investments. Even more expansionary fiscal policy could only have added to these fears.

The uncertainty that Japanese investors had regarding the economy is manifested in reduced investment. After the initial bust of the business cycle runs its course, entrepreneurs should theoretically regain confidence in the economy. But, if uncertain conditions due to government actions persist, investors will remain wary and invest less.[[7]](#footnote-7) Statistics from the World Bank reveal that gross capital formation as a percentage of GDP consistently decreased from 32% in 1991 to 24% by 2001. This is an enormous decline that reveals just how hesitant entrepreneurs were during the 1990’s. Along with the growth of government debt, serious issues in the financial sector were a burden on the Japanese economy during the 1990’s.

***Financial Sector Problems***

As addressed earlier, financial markets, especially banks, were constantly threatened by bankruptcy. During the initial crash, it has been estimated that the value nonperforming loans topped 16% of GDP (Lincoln and Friedman 1998, pp. 356-7). Bank failings were even more acute in 1997 and 1998. Banks as a whole, between 1993 and 2003, did not record net profits. Total losses from banks during this period amounted to ¥91.5 trillion or approximately 18% of GDP. Of course, much of this is expected during a recession. Banks which loaned cash to investments that were not able to be completed are certainly expected to feel a lot of stress to meet their obligations. The loans that they cancel and losses that are incurred are necessary in the market’s correction process post-bust. But, as Hoshi and Kashyap argue, the problems that Japanese banks experienced during the 1990’s cannot be explained merely by asset price inflation and later deflation (2004, pp. 6-7). The decade-long issues with financial markets can be explained by more long-term structural and regulatory causes.

 The Japanese economy depends heavily on banks for financing and less on other financial institutions. Economists Hoshi and Kashyap point to regulations established during the 1960’s and 1970’s to explain this. Capital controls were instituted that seriously hindered overseas capital trades. Other regulations severely limited the development of nonbank financial markets like derivatives and swaps. For this reason, Japanese financing has been heavily dependent upon banks who struggle to find profitable uses for all of the funds that they receive by capitalists (2004, pp. 12-13). Thus, banks have been shielded from the competition that they would normally receive in an advanced, free market.

 More recently, the extremely low interest rates enforced by the Bank of Japan since 1995 have kept insolvent banks alive. Troubled commercial banks can easily receive cheap loans from the central bank and continue operating. Deposit insurance for failing banks is extremely open with few restrictions (Hoshi and Kashyap 2004, p. 9). Banks that funded the entrepreneurial errors made during the boom times continued to thrive from low interest loans and further supplies of new money from the Bank of Japan. The unprofitable firms, also known as “zombie firms,” continue to borrow money from the banks while other, more profitable firms have gotten the short end of the stick. The central bank’s easy money policy has prevented the market from truly being governed by profit and loss.

 Even more destructive to the economy, Japanese commercial banks were often encouraged to “ever-green” during the 1990’s. “Ever-greening” is the process by which a bank knowingly makes loans that will not be paid back in time. Why would they be so foolish? It is believed that banks are heavily pressured by the government to make these loans to high-profile companies. Without them, the companies would go bankrupt, unemployment would spike, and confidence in the economy would fall. For example, seventy-three commercial banks continued to lend to the retailer Sogo in 1999, even though it was apparent to all observers at the time that their debts could never be repaid. Sogo failed a year later and owed ¥1.1 trillion (Hoshi and Kashyap 2004, pp. 14-5).

In addition to pressure from the government, it often directly bailed out troubled firms during the 1990’s. After Tokyo Kwoya and Anzen failed in 1994, the Ministry of Finance directly funded the deposits at these organizations. As noted earlier, the losses of seven jusen companies were partially covered by public funds in 1995 and a bailout package in 1998 covered ¥30 trillion in losses from other financial institutions (Nakaso 2001, pp. 3-8). The failing Resona bank, a merger of two large banks, received ¥1.1 trillion in public funds in 1998 and 1999. In 2003, the institution was fully insolvent (Hoshi and Kashyap 2004, pp. 24-5). The Japanese government, concerned about unemployment, failed to allow companies to go bankrupt and thus, hampered prospects for economic recovery. Since banks receive so much protection and assistance from the state, it is also quite possible that it has been directly assisting banks in their efforts to expand credit by suggesting certain lines of investment. This would mean that the boom and bust cycle was even more of a statist creation. In which case, it was even more destructive

The Fiscal Investment and Loan Program (FILP) is yet another institution of the Japanese government which seriously interferes with the market economy. Unlike most industrialized nations, the Japanese postal service has a savings account that customers can invest in and earn a higher return than elsewhere on the market. These funds go directly to the FILP which lends money to government agencies, government projects, and long-term mortgages. This agency is not included in the government budget, so it does not receive much oversight. Twenty-two of the twenty-eight agencies in FILP recorded losses in 2003. In total, this amounted to ¥78.3 trillion, or 15% of GDP in losses (Hoshi and Kashyap 2004, pp. 21-3). It is no wonder that the business community opposed this government postal savings system (Fletcher 2012, pp. 22-3). By charging less fees on their investments, the FILP crowds out private investment and directs it into government-sponsored uses.

The nature of Japanese financial markets and the behaviors that the government encourages through its regulations have kept the Japanese economy from correcting for errors. Low-interest rate policies at the Bank of Japan, government pressure to “ever-green,” and direct bailout funds have encouraged commercial banks to keep failing firms and unprofitable projects afloat. Government lending pushes real savings into less profitable investments. When the economy should have been punishing poor business decisions through earning losses, the government stepped in, prevented this, and kept the market from correcting for past errors. Government machinations to ease the pain of the bust only extended it indefinitely. This is one reason why economic growth was so sluggish in the 1990’s.

***Cartelization and Employment***

The highly cartelized nature of the Japanese economy also has reaped damage through fixing prices above their market levels and hindering labor mobility. As was noted earlier, an economic bust is shortest when the state takes the control of the economy out of its hands and into the hands of the market. Only when the market is free can labor move and prices adjust to levels which reflect the preferences of consumers in the economy. As Murray Rothbard remarks, “The more the government intervenes to delay the market’s adjustment, the longer and more grueling the depression will be, and the more difficult will be the road to complete recovery. Government hampering aggravates and perpetuates the depression” (2000, p. 19). Thus, the multi-decade-long nature of Japan’s slump is revealing about the nature of the Japanese economy: it is a highly hampered market.

 Robert Cutts, in his article entitled “Capitalism in Japan: Cartels and Keiretsu,” writes in great detail about one aspect of this hampered market. He believes that cartels are practically intrinsic in Japan; particularly one business relationship known as *keiretsu*. Cutts defines keiretsu as “long-lived, intimate relationships among suppliers and customers.” These relationships are informal and deemed illegal by most Western observers. But in Japan, they are something of an established social contract. “Politics, society, and business are ensnarled because the Japanese believe that these insular arrangements maintain the security of the nation, provide full employment, and distribute the burden of risks of all sorts.” The widespread cartelization of the Japanese economy is supervised and aided by the government for large and small industries; it is crony capitalism par excellence.

 Manufacturing keiretsu essentially organize entire manufacturing industries into one enterprise which sets prices. Cutts found in 1992 that rice was four to five times more expensive in Japan because the state enforced a subsidy given to the massive agricultural cartel, *Nokyo*, and its affiliated farmers.[[8]](#footnote-8) The equipment that Nokyo provided was valued at 30 to 40% more than typical imports. Nokyo also received other government grants and tax breaks. As of 1992, the public works industry in Japan was only legally allowed to have five contractors that were approved by the government. This system keeps out competition and is far more expensive than a free bidding system would be. Though Cutts argues that most companies in Japan could be punished for violating anti-trust laws, 40% of the Japanese economy in 1987 was either regulated or directly administered by the government and the cartels are therefore protected from prosecution. The Japanese state during the 1990’s permitted and enabled the pervasive existence of protectionist cartels which prevented prices from moving to appropriate levels.

 From an international perspective, the Japanese economy was by no means free. The domestic cartels are protected not through traditional import barriers, but through discriminatory customs and licensing procedures. Japan, compared to the rest of the industrialized world, has very few imports (Lawrence 1992, pp. 5-6). Though Japanese investment was only 5% of American foreign direct investment in 1992, it accounted for 35% of all American receipts from foreigners. Japanese foreign affiliates, which manage trade into Japan, place high markups on goods and act basically as a private tariff system (Lawrence 1992, pp. 7-9). Keiretsu were on the front lines in modern Japanese protectionism during the bust. By setting prices and coordinating domestic production, keiretsu shut out competition from lowering prices. They are estimated to reduced imports into Japan by half and increase prices (Lawrence 1992, pp. 11-14). Faced with a rigid capital structure, Japanese and international entrepreneurs face difficulties when adjusting to new economic realities like the collapse of capital values.

 Japanese officials, through a series a laws in the 1970’s, restricted the market even further during recessionary times. If an industry is failing, the government is supposed to recommend firms to form a recessionary cartel to reduce capacity, keep prices high, and reduced the threat of unemployment. These recessionary cartels are specifically protected by Japanese antimonopoly laws (Peck, et. al. 1987, pp. 84). Another law from 1978 allows the state to offer subsidies to failing firms so that they can continue to pay employees or held them find new jobs. In general, it is essentially written into the Japanese law code that firms have the responsibility to provide lifetime employment for their employees. The government is responsible for reducing the costs through loans, tax cuts, and consulting services (Peck, et. al. 1987, pp. 88-92). Japan has attempted to make unemployment impossible, which partly explains why the unemployment rate was so low by American and European standards during the early years of the lost decades.

 The cartelized and rigid nature of Japan’s hampered economy has forced the bust that began in 1989 to last far longer than it should have. After decades of interlocking business and government interests artificially increasing prices, the economy struggled immensely during the 1990’s. “In the wake of the Tokyo stock market fall, there are signs that these older cartel frameworks are becoming too expensive to maintain not only for consumers but also for the sponsoring manufacturers,” said Cutts. Japanese industries could not compensate for the failed investments of the late 1980’s because they were essentially centrally controlled by government-sponsored managers. Japanese firms, when threatened by bankruptcy, could not easily lay off workers to reduce costs. Firms which should have failed were encouraged to stay afloat through government-approved collusion with other firms. They were also shielded from international competition. The Japanese economy in the 1990’s was nowhere near free and was not equipped to make the necessary corrections for mal-investments. This has seriously elongated the length of the recession.

**Lost *Decades?***

Based on the GDP and unemployment statistics during the 1990’s, there is little doubt that Japan was in the midst of a recession. Most mainstream economists also point to the deflation that started during the middle of the decade as proof that Japan experienced economic malaise. Their view is that lower prices deepened debt. However, there is not necessarily any reason why deflation is any worse than inflation. If all prices in the economy are lower, then production continues as normal. If anything, deflation is a manifestation of the public’s greater desire for liquidity in the midst of government controls and it helps put a stop to monetary inflation. It is for this reason, among others, that some less mainstream economists assert that the lost decades narrative is a myth.

 Kel Kelly, when writing for the Mises Institute, believed that Japan did not actually experience a recession because GDP statistics are unreliable and unneeded (2011). She also used survey evidence collected by Gary North that shows that economic activity still flourished in Japan. The lower prices have had enormous benefits for Japanese consumers. She rightly counters the notion that economic growth should be measured by how much money is in the economy and instead insists that economic growth is based on economic production and satisfied preferences (2011). Eamonn Fingleton believed that Japan’s increased life expectancy, improving technology, rising Yen, and current account surplus demonstrates that the situation was not all the terrible for Japan during the 1990’s and into the 2000’s (2012).

Though I do not disagree with these assertions, Japan did experience a business cycle during the 1980’s and 1990’s. This, as Austrian economists should know, consumes capital goods and causes unemployment. The effects are even worse when a business cycle occurs in a mixed economy like Japan’s. Since the stock market crash, the number of suicides has increased by over 1,000 each year and the homeless population nearly doubled between 1997 and 2003 (MacLean 2006, p. 103). Individual bankruptcies increased from 43,545 in 1993 to 122,741 in 1999 (Sawada, et. al. 2011, p. 298). Sure, condos are being built and some people are confident about the economy, but this just shows that the market, through entrepreneurs, asserts itself even when faced with adversity. It ignores the fact that real economic destruction has taken place. Just because things could be worse does not mean that the lost decades are a façade.

***Conclusion***

Upon examining the historical evidence and the basic tenets of the Japanese regime, it is abundantly clear that Japan unnecessarily suffered through years of economic unease. As a result of pressure to offset the increasing value of the Yen in the 1980’s, the Bank of Japan rapidly increased the money supply between 1987 and 1989. The new and higher capital values did not reflect social time preferences and mal-investments resulted. The Bank of Japan started the readjustment process of the bust by abruptly increasing its interest rates in 1989.

Though capital values fell, the economy never escaped the doldrums that it entered. Increased government spending and higher taxes directed management of the economy out of the hands of private entrepreneurs and into the hands of the bureaucrats. The state encouraged banks to continue to lend cheap money to unprofitable firms. Most firms, part of a vast network of government-cartel interactions, were unable to quickly adjust to the changing structure of prices. Firms truly governed by profit and consumer preferences were forced to “compete” with government-aided firms shielded from international and domestic competition. The persistent existence of insolvent banks and other institutions kept growth at meager levels and encouraged economic participants to hold onto their cash and not save and invest as much. The Bank of Japan tried repeatedly to increase credit through record-low interest rates, but this policy encouraged banks to increase their reserves and cover the bad investments that they were making. Though Japan remained an advanced economy, its long-term economic crisis caused unnecessary destruction to a wealthy society.

Even when a government perpetually and unsuccessfully hampers an economy to alleviate recessionary trends, economists like Paul Krugman and Ben Bernanke can justify their proposed policies by simply claiming that the government has not done enough. But when does the inflation stop? How much debt is too much debt? Governments can try the much safer route, albeit more politically costly, of reducing their role in the economy. The public officials and citizens alike would discover that much of the economic suffering is avoidable and self-imposed. Krugman believes that his criticisms of Japan’s government are more relevant now than ever. The relevance of Japan’s lost decades that Krugman should acknowledge is that the state is often the cause of economic difficulties and not the medicine.

Bibliography

Bernanke, Ben S. 2000. “Japanese Monetary Policy: A Case of Self-Induced Paralysis?” in

 *Japan’s Financial Crisis and its Parallels to U.S. Experience*, edited by Ryoichi

 Mikitani and Adam S. Posen, the Institute for International Economics: 149-66.

Cargill, Thomas F., Michael M. Hutchison and Takatoshi Ito. 1997. *The Political Economy of*

 *Japanese Monetary Policy*. Cambridge, MA: MIT Press.

Cutts, Robert L. 1992. “Capitalism in Japan: Cartels and Keiretsu.” *Harvard Business Review*,

 July, 1-7.

Fletcher, Miles W. 2012. “Dreams of Economic Transformation and the Reality of Economic

 Crisis in Japan: Keidanren in the Era of the ‘Bubble’ and the Onset of the ‘Lost Decade,’

 from the mid-1980s to the mid-1990s.” *Asia Pacific Business Review* 18 (2): 149-165.

French, Doug. 2012. “Illusions of the Age of Keynes.” *Townhall.com*, September 18.

Fingleton, Eamonn. 2012. “The Myth of Japan’s Failure.” *New York Times*, January 6, the

 Opinion Pages.

Grimes, William W. 2001. *Unmaking the Japanese Miracle: Macroeconomic Politics, 1985-*

 *2000.* Ithaca: Cornell University.

Hattori, Masazumi and Hyun Song Shin. 2009. “Yen Carry Trade and the Subprime Crisis.”

 *IMF Staff Papers* 56 (2): 384-409.

Hayashi, Fumio and Edward C. Prescott. 2000. “The 1990’s in Japan: A Lost Decade.” *Journal*

 *of Economic Literature*: 1-38.

Hoshi, Takeo and Anil K. Kashyap. 2004. “Japan’s Financial Crisis and Economic Stagnation.”

 *The Journal of Economic Perspectives* 18 (1): 3-26.

Ihori, Toshihiro, Toru Nakazato and Masumi Kawade. 2004. “Japan’s Fiscal Policies in the

 1990s.” in *Japan’s Lost Decade: Origins, Consequences and Prospects for Recovery*,

 edited by Gary R. Saxonhouse and Robert M. Stern, Oxford: Blackwell Publishing: 59-72.

Iwata, Kazumasa and Shinji Takenaka. 2012. “Central Bank Balance Sheets Expansion: Japan’s

 Experience.” *Japan Center for Economic Research*.

Kelly, Kel. 2011. “The Myth of Japan’s Lost Decades.” *Mises Daily*, April 15.

Krugman, Paul R. 2014. “Apologizing to Japan.” *New York Times*, October 30, the Opinion

 Pages.

\_\_\_\_\_\_\_\_\_. 1999. “It’s Baaack: Japan’s Slump and the Return of the Liquidity Trap.”

 *Brookings Papers on Economic Activity* 2: 137-204.

Kuttner, Kenneth N. and Adam S. Posen. 2001. “The Great Recession: Lessons for

 Macroeconomic Policy from Japan.” *Brookings Papers on Economic Activity* 2001 (2):

 93-106.

Lawrence, Robert Z. 1992. “Japan’s Different Trade Regime: An Analysis with Particular

 Reference to Keiretsu.” *The Journal of Economic Perspectives* 7 (3): 3-19.

Lincoln, Edward J. and Benjamin M. Friedman. 1998. “Japan’s Financial Problems.” *Brookings*

 *Papers on Economic Activity* 1998 (2): 347-85.

MacLean, Brian K. 2006. “Avoiding a Great Depression but Getting a Great Recession.”

 *International Journal of Political Economy* 35 (1): 84-107.

Mises, Ludwig von. 1944. *Bureaucracy*. New Haven: Yale University Press.

Nakaso, Hiroshi. 2001. “The Financial Crisis in Japan during the 1990s: How the Bank of Japan

 Responded and Lessons Learnt.” *Bank for International Settlements* (6): 1-76.

Ogawa, Eiji. 2000. “The Japanese Yen as an International Currency.” Presented at KIEP/NEAEF

 Conference on Regional Financial Arrangements in East Asia: Issues and Prospects.

Ogawa, Kazuo. 2007. “Why Commercial Banks Held Excess Reserves: The Japanese Experience

 of the late 1990s.” *Journal of Money, Credit, and Banking* 39 (1): 241-257.

Okia, Kunio, Masaaki Shirakawa and Shigenori Shiratsuka. 2001. “The Asset Price Bubble and

 Monetary Policy: Japan’s Experience in the Late 1980’s and Lessons.” *Monetary and*

 *Economic Studies* *(Special Edition)*: 395-450.

Peck, Merton J., Richard C. Levin and Akira Goto. 1987. “Picking Losers: Public Policy

 Towards Declining Industries in Japan.” *Journal of Japanese Studies* 13 (1): 79-123.

Rothbard, Murray. 2000. *America’s Great Depression*. Auburn, AL: Mises Institute.

Salerno, Joseph P. 2012. “A Reformulation of Austrian Business Cycle Theory in Light of the

 Financial Crisis.” *The Quarterly Journal of Austrian Economics* 15 (1): 3-44.

Sawada, Yasuyuki, Kazumitsu Nawata, Masako II and Mark J. Lee. 2011. “Did the Financial

 Crisis in Japan Affect Household Welfare Seriously?” *Journal of Money, Credit, and*

 *Banking* 43 (2-3): 298-323.

World Bank. 2014. “World Development Indicators.”

 http://data.worldbank.org/data-catalog/world-development-indicators.

1. Specifically Krugman’s “It’s Baaack: Japan’s Slump and the Return of the Liquidity Trap” and Bernanke’s “Japanese Monetary Policy: A Case of Self-Induced Paralysis?” [↑](#footnote-ref-1)
2. For a more detailed summary of the Austrian business cycle theory, see Murray Rothbard, *America’s Great Depression* (Auburn, AL: Mises Institute, 2000), 3-29. [↑](#footnote-ref-2)
3. Consult Kunio Okia, Masaaki Shirakawa and Shigenori Shiratsuka, “The Asset Price Bubble and Monetary Policy: Japan’s Experience in the Late 1980’s and Lessons,” *Monetary and Economic Studies (Special Edition)*(2001): 432-43. [↑](#footnote-ref-3)
4. Endaka literally means “appreciation of the Yen.” [↑](#footnote-ref-4)
5. The financial crisis of 1997 will be addressed in greater detail below. [↑](#footnote-ref-5)
6. For a fuller treatment of bureaucratic management in comparison to profit management, see Ludwig von Mises, *Bureaucracy* (New Haven: Yale University Press, 1944), 20-57. [↑](#footnote-ref-6)
7. Joseph T. Salerno in “A Reformulation of Austrian Business Cycle Theory in Light of the Financial Crisis” explains this process in greater detail. [↑](#footnote-ref-7)
8. The given statistics were based on Cutts’s findings in his article from 1992. [↑](#footnote-ref-8)