A Heterodox view of Japan’s ‘Lost Decade’
Economic overview, 1988 to 2018

Over the past 30 years the Japanese economy has experienced the bursting of an asset price bubble, marking the end of a “Japanese miracle” that began in the 1950s, a subsequent “lost decade” of economic stagnation lasting over a quarter of a century, and the 2011 Tohoku earthquake and tsunami costing thousands of lives and triggering a meltdown at the Fukushima Daiichi Nuclear Power Plant. The Bank of Japan and policymakers have responded to these struggles with neoliberal, Keynesian and unconventional policies, including negative interest rates, all to little avail. This paper will provide snapshots of various segments of the Japanese economy since 1988 with both orthodox and heterodox interpretations, and give policy guidance for moving forward.

To fully appreciate Japan’s plight, consider the country’s experience post-World War II. By the time Japan surrendered unconditionally to the Allies in 1945, the country had almost literally been bombed back to the Stone Age. Numerous factors contributed to Japan’s high growth beginning in 1950, including trade policy dependent on closed markets at home and aggressive export drives abroad, human resources including a dedicated unionized workforce, free riding under the American nuclear umbrella during the Cold War, and high consumption. Following the Plaza Accords of 1985, which sought to correct Japan’s trade surplus by strengthening the yen against the U.S. dollar, the Bank of Japan pursued expansionary monetary policy to prevent a recession (Tsutsui & Mazzotta, 2015). Japanese-style conglomerates—keiretsu—anchored to big banks filled their favored companies with more money than they could use efficiently (Overholt, 2002; Ito, 1997; Anderson & Makhija, 1999). This contributed to the great asset bubble of the 1980s when access to easy money and fear of
the rising yen led to an investment boom. The Japanese stock market reached a value of 49 percent of all the world’s stock markets combined. Due to the greatest real estate bubble in history the land under the emperor’s palace was valued at the same price as the entire state of California (Overholt, 2002). Tokyo’s 240 square miles were said to be worth more than all the land in the U.S. The Nikkei index hit its all-time peak of 39,000 on the last day of trading in 1989 (Tsutsui & Mazzotta, 2015). Anecdotes told of middle managers buying original Picasso paintings to adorn their offices and of secretaries hopping on planes to Paris after work Friday, indulging in shopping sprees, and flying back Sunday night to return to their offices Monday morning.

Following the end of the Cold War, Washington cut Tokyo adrift once the U.S. no longer had much reason to favor Japan and leaned on the country to undertake reforms, particularly opening its financial and consumer markets and allowing its currency to appreciate (Stratfor, 2012). Japan’s GDP per capita had reached 90 percent of U.S. levels by 1991. By 2001, they had tumbled to 76 percent. The Tokyo Stock Exchange fell to 14,000 by 1991 and bottomed out at 8000 in the early 2000s (Tsutsui & Mazzotta, 2015).

Shinzo Abe came into the office of prime minister in a landslide election in December 2012. He launched an aggressive set of economic policies known as “Abenomics,” which included massive monetary and fiscal stimuli such as negative interest rates, monetary easing and bond purchases by the central bank. All this liquidity spurred consumption and inflation in the short-term, but after a year, the familiar stagnation returned (Tsutsui & Mazzotta, 2015).
Japan’s consumer price index from July 1988 to July 2018 has averaged 0.5 percent, 3 points lower than the OECD average of 3.5 percent, with numerous bouts of deflation. Figure 1 shows a moderate correlation ($r = 0.5$) between price inflation in Japan and the OECD average.

Former Bank of Japan Governor Masaaki Shirakawa attributed deflation in Japan to low growth outlook impacting expected future income and hence consumer spending. He believed this was the main cause due to the inability of Japan to shake off deflation with expansionary financial conditions. The BoJ has a mandate to maintain price stability as a condition of its independence, and Shirakawa (2012) said, “Central banks should not waver in the face of unpopularity, and the society at large must be ready to acquiesce.”
GDP growth in Japan is strongly correlated with the OECD average ($r = 0.7$) and averaging 0.78
points below the OECD (Figure 2). Per capita GDP has kept pace with the OECD average, despite low growth, due to Japan’s shrinking population (Figure 3).

**Inequality**

![Chart showing share of top incomes in total revenue for Japan from 1900 to 2010.](image)

*Figure 4. Source: Piketty, 2013 (Data unavailable for 1946)*

From the turn of the 20th century until the end of World War II, Japan had been a highly unequal society, with the share of income going to the top 1 percent reaching 19.9 percent in 1938—near the current level in the U.S. Japan has been fairly egalitarian following World War II, with the share of income going to the top 1 percent averaging 7.8 percent between 1945 and 2010 (Picketty, 2013). The Gini index for Japan measured 32.1 in 2008 (World Bank, 2018; the Gini index for the U.S. was 41.5 in 2016). Income inequality has crept up since the bursting of
Japan’s asset price bubble. In 1988 the share of income going to the top 1 percent was 7.6 percent. By 2010 the share had increased to 9.5 percent—a 25 percent increase (Picketty, 2013; see Figure 4).

Uemura and Tahara (2014) noted the traditional system of negotiating wages each spring—*shunto*, meaning spring offensive—collapsed in the ‘90s with the weakening of trade unions. This led to a sharp fall in wage share to workers. Oshio and Kobayashi (2010) documented the correlation between a rising Gini coefficient and deterioration in perceived happiness and self-rated health.

*Employment & unemployment*

Unemployment rose dramatically as Japan deindustrialized in the 1990s and regular workers in the manufacturing sector lost their jobs (Uemura & Tahara, 2014). Manufacturers have shifted investment abroad, causing a hollowing-out phenomenon in Japan (Ito, 1997). Unemployment
began to fall in the early 2000s until the economy was hit by the Global Financial Crisis in 2008, which created a strong pressure on firms to reduce employment (Uemura & Tahara, 2014).

The currently low unemployment rate of 2.6 percent (as of August 2018; see Figure 5) masks the shift to a non-regular workforce. The ratio of part-time workers in the total employment increased from 16.3 percent in 1997 to 23.7 percent in 2004 (Uni, 2007).

**Yen to USD exchange rates**

![Graph showing yen to USD exchange rates from 1988 to 2017](image)

*Figure 6. Source: OECD*

The yen’s strength to the dollar is somewhat cyclical. As Japan’s economy is export-based, when the yen strengthens against the dollar, output falls somewhat. Figure 5 shows at the end of the bubble economy, the yen was weak at 145 yen to the dollar. The yen reached its peak at 94 yen
to the dollar in 1995, then finished the ‘90s at 114 yen to the dollar. The yen strengthened again during the Global Financial Crisis, and topped out at 80 yen to the dollar following the Tohoku earthquake and tsunami. The yen began to weaken in 2012 thanks to Abenomics. However, as the correlation between GDP and yen-to-dollar exchange rate was weak ($r = 0.35$), other factors besides business cycle fluctuations may better explain the rise and fall of the yen.

*Trade balance*

![Graph showing trade balance](image)

*Figure 7. Trade balance, compares the U.S.’s top four trading partners, including Japan, from 1988 to 2017. Source: OECD.*

Figure 7 shows Japan has the highest current account balance between the U.S.’s top four trading partners, at 4.0 percent of GDP in 2017, compared to 1.3 percent for China and -2.3 percent for the U.S. This has risen from 0.8 percent in 2014, despite structural changes in the Japanese economy in which business-related, consumer and public services have grown in both
Interest rates

Japan has dabbled in unconventional monetary policy by implementing negative long-term interest rates throughout most of 2016 (Figure 9). The BoJ adopted a remuneration schedule dividing balances in the current accounts of financial institutions into three tiers, with the tiers remunerated at +10 basis points, 0 bp and -10 bp, respectively (Bech & Malkhozov, 2016).
Orthodox vs heterodox interpretations

Orthodox and heterodox economists have differing viewpoints on the state of the Japanese economy, which lead to wildly different policy recommendations. Orthodox strains of economics refers to the neoclassical schools, exemplified by the University of Chicago and economists like Milton Friedman, who see themselves carrying the torch of classical authors such as Adam Smith, David Ricardo, J.B. Say, with a heavy influence from the Austrian School, particularly Friedrich Hayek. Heterodox currently refers to everything outside the orthodox strains, but in this paper specifically means schools of thought influenced by Karl Marx and John Maynard Keynes, such as Post-Keynesians, the French Regulation School and Modern Monetary Theory (out of the University of Missouri-Kansas City). MMT economist Bill Mitchell, in particular, has been critical of Japan’s turn to unconventional monetary policy such as
quantitative easing and negative interest rates influenced by orthodox monetarist economics (with Wray and Watts, 2016).

Japan’s economic challenges are stagnant growth, persistently low inflation punctuated by bouts of deflation, and general government debt of 234.55 percent of GDP (OECD, 2017). Japan faces these challenges with a graying population while recovering from the Tohoku earthquake and tsunami.

Orthodox economists blame Japan’s long-running malaise on “standard Keynesian solutions” (Overholt, 2002, p. 139). Harvard’s William H. Overholt (2002) claims Western economists, “reasoning by analogy from the Great Depression” (p. 139), argue for cheap money and more fiscal spending, which he says exacerbate Japan’s underlying problems. Cheap money has encouraged banks and corporations to keep carrying and increasing bad assets. Fiscal spending has subsidized inefficient sectors, such as construction. Ito (1997), however, notes, “Despite the image of interventionist government, public expenditure as a percentage of GDP in Japan has been relatively small compared with other industrial countries” (p. 17). Hiroyuki Uni, a Regulation School economist at Kyoto University, blames stagnation on a slowdown in export demand and stagnant investment demand due to overcapacity created during the bubble economy and price decreases in investment goods (2007).

Overholt goes on to say reforms are needed because “the 1940 system” — in which the government favored certain industries — “is about to run out of money. The largess the system provided can simply no longer be afforded, and the graying of Japan’s population will only make matters worse. The unsustainability of the 1940 system has ceased to be a question of politics; it has become a matter of simple arithmetic” (p. 140).
MMT demonstrates a country with its own sovereign currency is incapable of running out of money. If a country can issue fiat currency, ability to pay is a moot point. An economy is constrained by its overall productive capacity rather than the amount of currency it has on reserve (Mitchell, Wray & Watts, 2016). Overholt appears to acknowledge this point when, after noting Japan hasn’t taken the sort of aggressive reforms South Korea took in 1997, says: “One reason for this inaction is that Japan’s financial liabilities are denominated in local currency. Consequently, the country has avoided a foreign-exchange crisis and, unlike South Korea, has not been forced to answer to the International Monetary Fund” (p. 140). Indeed, Mitchell, Wray and Watts (2016) illustrate countries with debt crises had borrowed heavily in foreign currencies. As Japan’s liabilities are denominated in yen, which the BoJ has a monopoly on issuing, Japan will always be able to make its payments. Orthodox economists might argue printing more money (or, in reality, creating electronic entries at the central bank) would drive up inflation, Japan clearly has not had this problem, despite all the easy money in the economy.

Mitchell, Wray and Watts (2016) have also been critical of Japan’s turn to unconventional policies, particularly near-zero interest rates. They blame this move on neoliberal ideology which views monetary policy as the only appropriate area for government involvement in the economy. They point out the reason demand is low in Japan is not because banks are reluctant to lend money, necessitating near-zero (or negative) interest rates in order to tax excess reserves, but because Japan has a weak consumption sector and firms are able to meet demand without borrowing.

Low demand can be attributed to several factors. One is low consumer confidence (Overholt, 2002). People aren’t confident about their future earnings, so they prefer to save their
money. Indeed, the Japanese household saving rate has fluctuated between 15 percent and 20 percent since the 1950s—the highest among the major OECD countries (Ito, 1997). Tsutsui and Mazzotta (2015) blamed Japanese consumers for not doing their part and spending to boost growth, although they admitted saving was the rational response to the population’s financial uncertainty. (That high savings rate can also be partially explained with the MMT sectoral balances framework [Mitchell, Wray & Watts, 2016]. Japan’s current account balance surplus and government deficits indicate surplus cash flowing to the private sector.) Another factor for low demand is deflation. When consumers think a commodity will be cheaper next year, they might delay major purchases they don’t not have an immediate need for. Finally, Japan’s demographics may be another reason contributing to low demand. With 27 percent of its population aged 65 or over (Ministry of Internal Affairs and Communications, 2015), Japan is the “grayest” country in the world. Retirees on a fixed income and not expecting to outlive their purchases won’t splurge on consumer durables (Ivan Velasquez lecture, November 6, 2018).

**Policy recommendations**

Japan’s recent experience with unconventional monetary policy suggests it hasn’t been effective in stimulating the economy. Bech and Malkhozov (2016), who take a strictly practical approach in evaluating implementation of negative interest rates, note the difficulty in isolating the effects of negative interest rates on the broad economy due to the concurrent effects of quantitative easing and other noise. Negative rates would likely need to be deeper or sustained longer to understand their effects.
Rather, Japanese policymakers should aim at raising aggregate demand, particularly within the consumption sector. That’s not to say, however, Japan has shunned Keynesian solutions. Prime Minister Abe’s right-of-center Liberal Democratic Party has traditionally favored pork-barrel spending on useless concrete infrastructure. Since the beginning of the Lost Decade, mountains have been leveled for gravel to crush into concrete. With the exception of some remote parts of the snowy northern island of Hokkaido, not a river or stream in the country is bare of concrete banks or at least one dam (see Image 1). Tsutsui and Mazzotta (2015) note such “fiscal stimulus did have short-term positive effects, but no matter how many new and often unnecessary bridges, dams, and highways the government created, long-term economic revival remained elusive” (p. 68).

All this is not to say Japan should abandon Keynesian solutions to stoke employment and consumption, but such solutions should be recalibrated to recognize the limitations of pouring concrete all over the countryside (that is if the yakuza—the Japanese mafia—which is heavily entrenched in the construction industry, allows it, of course). Uemura and Tahara (2014), writing from the perspective of the French Regulation School, suggested three steps to
stimulate growth: 1) Create and invest in dynamic industries that have a competitive edge, 2) promote innovation in personal services such as medical care, elderly care and higher education, and 3) establish the institutional structure to strengthen linkages between large export-goods manufacturing firms and the newly developed service sector.

Former BoJ Governor Masaaki Shirakawa said:

“The Japanese economy has stagnated and the rate of growth is sub-par among the major economies. Given that the 10-year average per capita GDP growth is comparable to other developed economies and per worker growth is the highest among its peers, the challenges facing Japan is not demography per se, but adapting to the rapidly changing demography, which no other country has so far experienced. The low aggregate growth and the huge fiscal hole are both largely the symptoms of the failure to adapt to the demographic reality” (2012).

Adapting to Japan’s aging population is certainly a challenge as a growing proportion of the population leaves the workforce and begins drawing entitlements. Drawing on MMT principles, the government should use fiscal policy to pay for benefits for senior citizens and not be frightened by an arbitrary ratio like debt-to-GDP as long as the workforce is productive and debt is denominated in yen.

Conclusion

Over the past quarter century Japanese policymakers have attempted numerous reforms, all of which started off promising, but ended in frustration. Tsutsui and Mazzotta (2015) write, “…the Japanese people have been impassive in the face of economic stagnation and patient, resilient, and resigned in the face of lackluster political leadership, falling standards of living, increasing
inequality, and growing uncertainty” (p. 71). The Japanese people deserve better leadership and should demand it. The BoJ has attempted to stoke growth through expedient monetary policy because the central bank “can put up a huge wall of money almost instantaneously” (Shirakawa, 2012), but if the Japanese hope to grow their economy to provide for their growing ranks of seniors, they need to recalibrate fiscal policy to focus on more productive sectors, rather than searching for the last inch of the country that hasn’t yet been cemented over.

Sources:


