Chapter 4

The Self-Trapped Japanese Economy – An Overview

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1. Introduction

In the 1990s Japan, as the most successful nation for economic performance, was struck with awe and consternation. While throughout the 1980s the US, UK and the European countries suffered from stagflation, Japan maintained high economic performance. Thus much attention was paid to the clue to the success of the Japanese economy, and the "Industrial Policy" by the MITI (Ministry of International Trade and Industry) and the "Japanese Way of Doing Business" were lionized.

In the late 80s there emerged great cracks in the Socialist Bloc which played its part in the Cold War System. In Eastern Europe the civil rights movement became increasingly active, in its efforts to shake off the yoke of the Soviet Union and introduce some sort of capitalistic system, Poland taking the leading role. The Soviet Union, no longer having the power to crush the movement, finally fell in 1991.

Since then twenty years have passed, and here we are in 2011. During this period the world has gone through great transformation and turbulence. The US achieved some economic growth thanks to the information technology revolution and financial globalization, while the UK enjoyed some growth due to financial globalization. More strikingly, what came as truly unexpected and surprising was the miraculous economic growth of China, India and Brazil, which have come to exert some influence over the world economy.

Japan, on the other hand, was left out in the cold: it tumbled by itself and remained stagnant – hence the so-called “Lost Decade” (or the “Lost Two Decades”).

It became a constant refrain to speak of Japan as the country which could still find no way out of the stagnation, or the one that held a lesson for all. Emblematic was Obama’s statement in the Presidential Inaugural Speech two years ago that he would implement any resolute policy for recovery of the US economy from the crisis, referring to the Lost Decade.

The present paper will look into the realities of the Lost Decade, examining the path along which the Japanese economy proceeded over the three decades.

2. The Misstep from the Supreme Reign

2.1. The Plaza Accord (1985)

In the 1970s the world economy saw the collapse of the Bretton Woods System and the advent of the flexible exchange rate system as a new currency system.

After the yen was fixed at 1 dollar = 308 yen at the Smithsonian Agreement (December 1971), Japan eventually came to adopt a flexible exchange rate system in February 1973. Immediately after that, the yen appreciated to 1 dollar = 260 yen, but remained stable at around 300 yen thereafter. Then a rapid appreciation of the yen occurred as from October 1977, arriving at 175 yen in October 1979.

Besides the change in the monetary system, the world economy also saw US-Japan trade conflict.

The Japanese firms, producing high-quality goods thanks to sophisticated technology, had rapidly expanded sales abroad and come to dominate the world market. In consequence Japan’s balance of trade continued to show a surplus, and so it was that trade conflict arose with the US. As huge exports to the US drove American firms to bankruptcy, the US began to criticize Japan in terms of unfair trade. This US-Japan trade conflict was to continue over the long period, starting with synthetic fiber, followed by steel products, color TV and cars. Japan usually responded to the US with self-imposed restraint. Its balance of trade surplus, however, rapidly increased from 1983 on, and US grievance waxed ever stronger.

At that time the US economy was suffering from stagflation. Volcker, who became the Fed chairperson in August 1979, implemented tight monetary policy ("New Adjustment Finance Method"), causing the FF rate to rise to 20 % ("Volcker Shock"). In consequence, although the price level rapidly stabilized, the unemployment rate rose further, reaching 11%. Due to the high rate of interest, huge amounts of dollars poured into the US, which caused considerable appreciation of the dollar (from 200 yen in October 1981 to 275 yen in October 1983). The exchange rate then settled at around 250 yen, which meant some depreciation of the yen, resulting in a rapid increase in the balance of trade surplus. The balance of trade in relation to the US also showed a huge surplus, which heightened the trade conflict.

It was in these circumstances that the "Plaza Accord" (September 1985) was concluded with strong initiative on the part of the US Administration. This was a pact among the G5 for cooperative intervention in the foreign exchange market. Its aim was, in essence, to appreciate the yen (depreciate the dollar) by selling dollars and buying yen.

In consequence, the exchange rate rose from 1 dollar=255 yen in October 1985 to 150 yen in October 1987. Thereafter the yen went on appreciating until it reached 125 yen in October 1988. Then it went on to depreciate for a while, and again appreciated until it reached 79 yen in April 1995.

In spite of this appreciation, Japan's balance of trade saw a large surplus persisting throughout the 90s.

2.2. The Bubble Period

Speaking of the recent bubble economy we may mention the real estate bubbles of the US, Ireland and Spain in the early 2000s. We can also mention the real estate bubble in Japan, which anticipated them. It continued from December 1986 to February 1991, and its collapse continued from the spring of 1991 to that of 1993.

2.2.1. The Upward Phase (December 1986 - February 1991)

Worries about Depression Induced by Yen Appreciation – As Japan's economic growth had been led by exports, worries spread that the steep yen appreciation due to the Plaza Accord might cause serious depression if the government did nothing. The surplus, in fact, continued to decrease in the balance of trade from 1987 to 1990.

The Nakasone Cabinet then implemented fiscal and monetary policies aiming at stimulating domestic demand. For fiscal policy it put forward the "Emergency Economic Measures" (May 1987) while for monetary policy it lowered the official discount rate to 2.5 % (February 1987 - May 1989). In consequence, public investment as well as private investment increased tremendously. Besides, the nation-wide project to develop the resort area was devised as a means to stimulate domestic demand ("The Resort Act", 1987).

The Japanese exporting firms adopted two methods to tackle the yen appreciation. One was to reduce production cost through a rise in labor productivity. The use of robots in the production process was emblematic of this approach, which amazed the world.

Another method was to transfer production bases abroad for cheaper labor cost. This was extensively carried out, to such a degree that it might have induced) de-industrialization. The ratio of production abroad to total production in the manufacturing sector, in fact, soared from 3.0 % in 1985 to 6.4 % in 1990 (the main location was South Eastern Asia[1]).

[1] This was a key factor for Southeastern Asia's dramatic economic development thereafter.

And yet Japan's balance of trade showed a healthy surplus, albeit continuously decreasing until 1991. Japan did not see worrisome depression, but maintained the boom thanks to the fiscal and monetary policies.

The Abode of Demons: The Change in the Financial Structure – Under these circumstances, the scene was set for major policy failures – a shift from indirect finance to direct finance (or self-finance) in the Japanese financial structure. As a result of a steep increase in exports, many firms emerged in possession of huge sums of money (the phrase, "Toyota Bank" was emblematic), and felt less need to depend on the banking institution for procurement of capital.

On top of that, the stock market was gaining in popularity, giving rise to a situation that made it easy for firms to procure capital through it. The stock price continued to go up, with the Nikkei Average Stock Price rising from 1,300 yen in 1986 to 38,900 yen in 1989. Around that time a social atmosphere emerged in which more and more housewives caught the bug of investing their money in equities and other financial assets (the so-called "Zai-Tech Boom").

This state of affairs had serious implication for the banks. So far the Japanese economy had continued along a high economic growth rate, and firms were eager to procure a vast amount of capital. As long as the stock market was underdeveloped[2], firms had no means of procuring capital other than borrowing it from the banks. People deposited a large proportion of their increased incomes in the banks (or post-offices), and yet this was not sufficient to meet the demand of the firms. As, moreover, the loan rate was fixed above the deposit rate, the banks were able to finance capital safely by means of rationing.

Then, due to a large-scale shift to direct finance and self-finance, this traditional method no longer served the purpose. In addition, due to the huge surplus in the balance of trade the foreign exchange reserves rose abruptly, which brought the money supply rap-

[2] It should be noted that this was not the case in the prewar period.

idly flowing into the banks. Thus the banks found themselves in a new situation, forced to look for new customers.

Thus the banks came to expand their business, including mortgage loans, stock loans, and free loans (usable for any purpose). Individuals and firms able to obtain loans purchased immobile properties, stocks and other financial assets.

As the property prices and stock prices started to soar, more and more people were eager to get loans, believing that the prices would rise instantaneously. When the prices promptly rose, the demand for loans increased yet further, which in turn drove property prices and stock prices up still further.

Gradually the people making transactions for the sake of pure speculation, carried away by get-rich-quick dreams, came to account for a large weight in the markets. In consequence, eventually the land value within the Yamanote Line reportedly came equal to the land value of the whole of the USA. The objects of the speculatively borrowed money were not confined to properties and stocks, but extended to golf club membership cards, valuable paintings, and even fancy foreign cars. And in fact the prices of these items continued to rocket.

These speculative activities seriously affected the manufacturing industry. Many manufacturing firms came to be devoted to speculation to such a degree that they almost forgot their primary business. There were firms which even boasted larger profits in “Zai-Tech” than profits in the primary business.

The speculative activities extended beyond the domestic to the world market. Speculative investment in properties, stocks, other financial assets, and artworks[3] increased at a faster pace. The purchase of the Rockefeller Center by the Mitsubishi Estate in 1989 was an emblematic case of such dealing.

[3] Successful bidding by Japanese in auctions such as Sotheby’s became all the news.

2.2.2. The Burst (February 1991- March 1993)

As the price of immobile property went up, the unlawful activity in connection with it (i.e. “Jiage”) became a major social problem. On top of it, unlawful loans by financial institutions (e.g., counterfeiting of the deposit account by bankers) came to light. Scathing criticisms was then voiced by the mass media and the public on property speculation and the loan stance adopted by the banks.

In response, the Treasury embarked on “the Regulation of the Total Sum concerning the Property Loan” (March 1990). This was an administrative directive designed to hold the rate of growth of the property loan below that of the total loan. In practice it acted as a tremendous pinprick, bursting the bubble.

It was, rather, the stock market which was initially affected. The Nikkei Average Stock Price, which was record-high at 38,000 yen in December 1989, plunged to 15,000 yen in 1992. Then the price of property, which had only seen a decline in the rate of increase even in 1991, dropped sharply. Many firms and individuals engaging in speculative activities were suddenly refused loans by the banks. They were forced to rush to sell their properties and equities, which caused further decline in the price of the stock and the properties. And the bubble burst there.

This, in turn, worsened the balance sheets of the banks and security companies which had made loans to these firms and individuals. It turned out to be difficult to retrieve loaned money, for more and more firms and individuals were pushed into default, and the value of the collateral possessed by the financial institutions plunged. In a word, the loaned money turned into bad debts.

The banks, which initially held the optimistic view that property value as well as the stock price would soon rise, tried to prevent the bad assets from coming to the surface. This they were able to do under the system of acquisition cost basis accounting, unless the bad assets were disposed of. However, this behavior was soon to be denounced by the mass media as “bad asset concealment”.

3. Recovery, Stagnation, and Recovery

When the bubble economy turned into depression, what kind of economic measures would the government implement? The phrase, "the Lost Decade" is quite often used to characterize the Japanese economy in this period. However, it is not true to say that all were doomed to failure from the start, for there was a period in which policy was seen to have some effect. It is premature to label it with the blanket term "the Lost Decade". Let us take the period in order.

3.1. Economic Stimulus Measures and Economic Recovery (1993-1996)

While property value and stock price were abruptly deteriorating, the government implemented the following economic stimulus measures, which had fiscal policy to boost effective demand as top priority.

(1) "The Overall Economic Measures" (August 1992. 10.7 trillion yen) by the Miyazawa Cabinet (November 1991 – August 1993).
(2) "On the Promotion of the Overall Economic Measures" (April 1993. 13.2 trillion yen) by the Miyazawa Cabinet.
(3) "Emergent Economic Measures" (September 1993. 6 trillion yen) by the Hosokawa Cabinet (August 1993 – April 1994).
(4) "The Overall Economic Measures" (February 1994. 15.25 trillion yen) by the Hosokawa Cabinet.
(5) "Economic Measures" (September 1995. 14.22 trillion yen) by the Murayama Cabinet (June 1994 – August 1995) together with a lowering of the official discount rate to 0.5 %.

Thanks to these measures, personal consumption and capital investment increased. The Japanese economy was able to accomplish an economic growth rate of 3.1 % in 1995 (as compared with the previous year), and 4.7% in 1996, and fear over the bad debt decreased. Fiscal policy was clearly having effect around this period.

3.2. Fiscal Structural Reform and the Financial Crisis (1996-1998)

Seeing the economically favorable situation, the Hashimoto Cabinet (January 1996 - July 1998) set its primary policy objective on fiscal structural reform. The cabinet raised the consumption tax by 2%, abolished the special tax break (2 trillion yen), and increased the burden on the public through health service reform (2 trillion yen), expecting to increase tax revenue by the total sum of 9 trillion yen.

Contrary to the expectation, however, the economy, which had been showing an upward trend, was to plunge again with this policy. In 1997 the stock price sharply dropped and the bad debt problem came to the surface. At the G10 summit in July 1998, moreover, it was decided that an international bank should maintain 8 % plus as the capital-to-asset ratio (the BIS regulation). The banks concerned carried out extensive credit crunch and credit withdrawal.

Thus the Japanese economy again deteriorated and, additionally, fell prey to financial crisis (the following bankruptcies occurred in succession: the Hokkaido Takushoku Bank and the Yamaichi Security Company [November 1997]; the Long-Term Credit Bank of Japan [October 1998]; the Nippon Credit Bank [December 1998][4]. Asset prices slumped while the number of bankrupt firms and individuals soared, which, in turn, worsened the balance sheet of the financial institutions.[5] The value of the bad debts possessed by the

[4] Ironically, it was in November that the "Fiscal Structural Reform Act" was enacted.

[5] The Housing Loan Companies ("Jusen") Problem became a hot issue in relation to property. They were subsidiaries for making loans to the property set up by the financial institutions. Even when "the Regulation of the Total Sum concerning the Property Loan" was implemented, money flew, through a loophole, into the Jusen from the financial institutions managed by the Agricultural Cooperation. The Jusen continued to make loans for property. However, this came to aggravate further the balance sheets of these financial institutions under the overall asset deflation.

banks, which amounted to 40 trillion yen in August 1995, jumped to 79 trillion yen in December 1997.

The Hashimoto Cabinet, which faced a serious depression, suspended the fiscal structural reform and implemented the "Overall Economic Measures" (16.7 trillion yen) in April 1998. However, the effect was not favorable. This should not be attributed to the fiscal policy, but rather to the fiscal structural reform, which is, by its very nature, a deflationary policy. The rate of economic growth in 1997 was 0.2 %, and -0.6 % in 1998.

The megabanks, which suffered from a steady decline in asset prices, finally appealed to the government for public funding. In consequence, the following bailouts were made: (i) (February 1998) 18 trillion yen for the 21 large banks including the Long-Term Credit Bank of Japan and the Nippon Credit Bank; (ii) (March 1999) 7.5 trillion yen for the 15 large banks[6] The mass media and public opinion denounced this as a continuation of the so-called "Convoy System".

Through the 90s, spending went to the tune of 18.6 trillion yen for the bankrupt financial institutions, 9.6 trillion yen to buy up the assets from the financial institutions, and 12.3 trillion yen for capital infusion into the almost bankrupt financial institutions[7].

The Line of Financial Liberalization - The collapse of the financial system in the latter half of the 90s constituted for the government a considerable inducement to leave the traditional "Convoy tem"[8]and promote financial liberalization (the "Japan-Version of the Big Bang"). This was carried out mainly by the Hashimoto Cabinet.

The plan was composed of two pillars. One pillar was the liberalization of securities, finance, and insurance.

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[6] The road to public funding for banks was paved by the "Early Promotion of the Financial Function Act" (October 1998).

[7] It is a historical irony that similar things were to be carried out on a larger scale throughout the world after the Lehman Shock.

[8] Another factor is pressure exerted by the US.

In November 1996 the Hashimoto Cabinet put forward an idea for the financial system reform, advocating “the three principles” (Freedom, Fairness and Globalization). The idea was implemented as the “Financial System Reform Act” (June 1998), which advocated: (i) deregulation of brokerage commissions; (ii) promotion of new entry into the banking sector, the security sector, and the insurance sector; (iii) shakedown of the investment trust; (iv) complete lifting of the ban on OTC (Over-the-Counter) derivatives; (v) enhancement of disclosure; (vi) upgrading of the rule of transaction.

This movement was closely tied to the financial liberalization carried out in the US, where the Glass-Steagall Act (1933) was mutilated and eventually taken over by the Gramm-Leach-Briley Act (1999). The US strongly urged Japan to adopt the same approach.

Another pillar was overhaul of the bureaucratic machinery. In June 1998 the Hashimoto Cabinet separated the Bureau of Check and Oversight from the Treasury in accordance with the “policy of separating fiscal matter from monetary matter”, and set up the “Financial Supervisory Agency”. In July 2000, moreover, the Mori Cabinet founded the “Financial Services Agency”, integrating the Financial Supervisory Agency with the Financial Planning Bureau of the Treasury. It is worth stressing that this reorganization brought about a weakening of the Treasury, which had so far flaunted absolute powers.

3.3. Economic Measures and the Economic Recovery (1998 –2000)

The Obuchi Cabinet (1998–2000), which was established in July 1998, when the Japanese economy spiraled downward and the financial system was in crisis, advocated recovery of the economy as top priority: (i) for fiscal policy, the “Emergent Economic Measures” (November 1998. 23.9 trillion yen) and the “Economic Renovation Measures” (November 1999); (ii) for monetary policy, the zero interest rate policy (February 1999). Thanks to these policies the Japanese economy clearly showed some recovery (November 2000).

Then the Bank of Japan lifted the zero interest rate policy (August 2000) although the Obuchi Cabinet opposed it. At that point the so-called “Dot Com Bubble” burst in the US, and the Japanese economy again showed a downward turn due to the decline in exports. The Bank of Japan again implemented the zero interest rate policy (together with the Quantitative Easing policy, March 2001. This was maintained until July 2006).

As compared with the fiscal policy, however, just how much the monetary policy helped in alleviating the economy is doubtful (see Table 3).

According to this table, the monetary base (the account current balance of the banks on the BOJ) showed a big increase in 2001 and 2002, while the rate of increase in money supply (the deposit balance of individuals and firms on the banks) was incredibly low. At that time the credit crunch held sway and the financial institutions were not inclined to make loans to the real economy. Rather, their usual practice was to purchase the national debt with the money obtainable.

(Table 1) Monetary Base and Money Supply (% compared with the Average Balance of the previous year)

	Monetary Base	Money Supply
97	8.2	3.5
98	7.4	3.7
99	9.8	3.2
00	3.8	2.2
01	14.7	3.1
02	21.8	3.2

(Source) BOJ Data

3.4. The Structural Reform and the "Izanami" Boom

It is the Structural Reform and the "Izanami Boom" (February 2002–October 2007) that characterized the Koizumi Cabinet era.

The Structural Reform was an inheritance of the Hashimoto Cabinet as well as representing explicit approval of "Market Fundamentalism" (or the Washington Consensus). The Koizumu Cabinet, which advocated small government and a balanced budget, persisted in a deflationary policy.

The zero interest rate policy by the BOJ attracted US investors who borrowed yen and exchanged them for dollars, which were carried over to the US and used for consumption and investment (the "Yen Carry Trade"). This in turn further boosted the US economy, which had already shown an upward trend. The Yen Carry Trade brought about a depreciation in yen, which induced a rapid increase in exports, due to which the Japanese economy was able to get on a modestly upward curve.

This situation continued from February 2002 to October 2007. Due to its considerable duration it was dubbed the "Izanami Boom", contrasting it with the "Izanagi Boom" (November 1965 – July 1970). However, this boom's beneficiaries were confined to the exporting firms and the financial institutions. At the same time restructuring proceeded in the whole industry; a great deal of labor employment was shifted onto a temporary basis; the level of income remained stagnant, and income disparity widened. Thus the general public had limited awareness of the actuality and benefits of the boom. And economic growth in this period was, in fact, very modest. No wonder it is also dubbed the “Kagerou (or Air Turbulence) Boom”.

3.4.1. The Structural Reform

The Koizumi Cabinet took a critical stance on the counter-cyclical measures and placed major emphasis on the structural reform, for which the Cabinet put forward the following: (i) privatization of the Postal Services, which was the main point of dispute in the general election in September 2005; (ii) privatization of the Highway Public Corporation; (iii) the Structural Special Zone; (iii) the Divine Trinity Reform; (iv) reorganization of the bureaucratic machinery.

It is doubtful, however, to what degree these reforms (some of which were not implemented) effectively contributed to revitalizing the Japanese economy. Many reforms were watered down and privatization was no more than a nominal change. Albeit the bureaucratic machinery was vertiginously overhauled, restructuring of public officials was not touched on at all. Although the Koizumi Cabinet emphasized the private economy (the market economy) and the reduction of activities by the state, the administrative reform dwindled into all bark and no bite.

The structural reform by Mr. Koizumi was carried out with the support of the general public. Although he was a maverick, he had a flair for populism which was unique in the Japanese political scene. When the mass media failed to show interest in a given reform, that structural reform plan came to an end without any substantial change as a result of power struggles behind the scenes. Then another plan for structural reform was put forward to attract the general public.

3.4.2. The "Izanami Boom" (February 2002 – October 2007)

Cavalcade of Deflationary Policy ― To repeat, the Koizumi Cabinet took a critical stance on the counter-cyclical measures. It implemented, in fact, a series of deflationary policies as follows: (i) a hike in the consumption tax rate; (ii) the abolition of income tax credit; (iii) an increase in health insurance premium; (iv) extension of retirement age.

They were founded on a microscopic (or microeconomic) idea of normalization (or equilibrium) of each account: (i) in order to solve the budget deficit, a hike in the consumption tax rate, and the abolition of income tax credit were advocated; (ii) in order to deal with the medical insurance fund deficit, an increase in the health insurance premium was advocated; (iii) to tackle the national pension fund deficit, extension of retirement age was advocated.

Of these, the medical insurance issue and the national pension problems are closely related to the aging problem facing Japan, so this is a very serious problem to tackle by any means. However, the reforms were implemented with bad timing. In a situation that saw no improvement for the general public, these measures aggravated their uneasiness about the future, which led to a fall in consumption (rise in the propensity to save).

What was really problematic was the stance the Koizumi Cabinet took on the budget deficit. A rise in the consumption tax rate, the abolition of income tax credit and a reduction of budget expenditure put heavy deflationary pressure on the Japanese economy.[9]

The Izanami Boom ―The above account, however, hardly does justice to the effects on the Japanese economy sufficiently in the Koizumi Cabinet period, for the boom dubbed the Izanami continued.

The Izanami Boom was brought about mainly as a side effect of the zero interest rate policy implemented in March 2001 (which

[9] The Structural Reformers have an allergic antagonism to fiscal policy, but they do not perceive that this can put deflationary pressure on the economy.

was maintained until July 2006). This policy gave rise to Yen Carry Trade on a huge scale. The US economy was beginning to recover, mainly in the housing market, from the 9.11 shock. It was American investors who showed an interest in the yen with zero interest rate. Borrowing yen and changing them into dollars in Japan, they used them to buy properties and financial assets in the US.

The Yen Carry Trade led to yen depreciation, so the Japanese exporting firms were able to make huge profits. The contribution ratio of the exports to the economic growth in this period, in fact, reached almost 60%. Due to increased exports, capital investment rapidly increased as well.

And yet, the annual rate of economic growth in terms of GDP was relatively low (2%). This was greatly affected by stagnation in consumption due to a deterioration in labor conditions (including a large-scale shift from normal employment to temporary employment and little or no increase in wages) and widening income disparity. The general public chose a life style to save (not to consume). The sales of the retail trade including the department stores and the supermarkets continued their prolonged decline.

The Izanami Boom was largely dependent on exports, lacking in domestic effective demand. Although the exporting firms and the financial institutions made huge profits, a sort of social uneasiness spread again due to the restructuring, the predominance of temporary employment[10] and little or no rise in wages. To the eyes of the general public who could not enjoyed no benefits, the Izanami Boom was the Kagerou (Air Turbulence) Boom.

3.5. After the Lehman Shock

The Lehman Shock, which broke out in September 2008, caused the collapse of not only the US economy but also the rest of the world economy. Far from being an exception, Japan suffered serious damage.

[10] The phrase “Working Poor” was coined.

Japan, as already noted, experienced the financial system crisis in the latter half of the 90s. During the Izanami Boom, however, the bad debt problem could finally be settled, and the financial institutions made unprecedentedly huge profits. Unlike the US and European financial institutions, the Japanese financial institutes were not involved in the financial bubble associated with securitized papers, for they were preoccupied with the bad debt problem.

The root cause of the deterioration of the Japanese economy was a sharp drop in exports, which was caused by the crisis of the US real economy. Almost all the exporting firms (including the car industry and the electronic industry) racked up huge losses, followed by massive restructuring and stoppage of investment. Consumption, which had long remained stagnant, showed further decline. Thus the Japanese economy abruptly spiraled downward. The stock price sharply dropped as well. Then there broke out speculative buying of yen. As the Japanese government did not intervene in the foreign exchange market, the yen peaked (76 yen) in March 2011.

Facing these critical conditions, however, the Japanese government was too worried about the huge budget deficit to implement counter-cyclical economic measures. Far from it, the bashing of "public investment" became a motto. The main policy of the Democratic Party included Child Benefits, Agricultural Individual Income Compensation, and Free Senior High School Tuition, none of which had anything to do with counter-cyclical measures. The government did not intervene in the foreign exchange market, fearing international reaction. The only counter-cyclical measures implemented were the zero interest rate policy by the BOJ (October 2010; this was the third time) and the Quantity Easing policy. However, even if money finds its way to the financial institutions through the QE (by buying the national debt), the project cannot work well, because of the credit crunch and credit withdrawal by the financial institutions on the one hand, and the feeble credit demand by the firms on the other.

During this period consumption has remained stagnant. Due to a sharp increase in unemployment the general public is uneasy about the cost of living and trying to limit consumption and save money, so we have the saving paradox. In the case of the firms, they are endeavoring to move their factories abroad because of yen appreciation, with the result that de-industrialization is under way. Thus investment remains low as well. Taking the stagnation in exports into account, all in all the aggregate effective demand is very low. Then Japan with its persisting deflationary situation has encountered the apocalypse of March 11, 2011 – the colossal Tsunami and the collapse of the atomic power plants in Fukushima.

4. Looking Back Over the Two Decades

4.1. Japan on the International Scene

Throughout the 80s the US economy suffered from serious stagflation. It was Japan and the West Germany that economically led the world, and Japan was coming into incessant trade conflict with the US. Albeit militarily and politically weak, Japan was outstanding in creating the highest quality manufactured goods through the endeavor of the firms (such as the Quality Control [QC) movement, and innovative technology). Economically speaking, Japan was distinctly top-drawer.

With abundant money supply at its zenith, however, the Japanese economy ran into the bubble, and property prices, stock prices and other asset prices shot up. Failure to tackle the bubble, the Japanese economy was to experience the Lost Decade. Then, helped by the Yen Carry Trade, it was able to maintain the “Izanami (or Kagerou) Boom”. Hit by the Lehman Shock, however, it again plunged into bottomless depression. Now severe instability descended both on the firms enjoying high reputation for “Japanese-style Management”, and on the laborers and salaried men who were regarded with awe as the “corporate warriors”.

The US saw liberalization (above all, financial liberalization) proceed on a large scale in the 80s. In this process the Shadow Banking System (SBS) was enlarged, and the US came to lead the world financially. This, together with the innovative IT industry, boosted the US economy in the 90s. The people went in for consumption while the firms regained self-confidence.

Excessive financial liberalization was, however, to put a great strain on the US economy. The USA had reacted smugly to Japan's Lost Decade, but ironically was now following the same path, to even worse effect, influencing the world economy.

In 1991 the Soviet Union collapsed, and a political situation emerged in which the US took on, also in military terms, overwhelming stature in the world. This, however, did not last long. The US was to be deeply involved in endless conflict in its "War on Terrorism".

In the same period, a phenomenon arose which was to transform both economy and politics in the world. China, Brazil and India, which had long been underdeveloped countries, continued to achieve surprisingly high economic growth. China, for instance, went on growing at an average of 8 % plus over the three decades, as a result of which it became No. 2 in terms of GDP, and No. 1 in terms of foreign currency reserves (2 trillion dollars).

Thus the economic and political structure of the world dramatically changed to such a degree that nobody had been able to foresee twenty years before. Today the presence of the Japanese economy in the world economy is manifestly in decline. While the Japanese economy remained stagnant, the US and the UK led the world in the financial area, and the BRICS and the Southeastern Asian countries raised their position in the area of the real economy.

Twenty years ago it was said that Tokyo was soon to become the world financial center together with New York and London. Now it's a dim memory. Then the Japanese manufacturing industry was proud of its overwhelming productive efficiency, thanks to the introduction of robots. Now it is lagging behind US industry in the IT area. It is, moreover, feeling Korean and Chinese firms at its heels. On top of this, while Korea and China built up a strong backup system through their governments, the Japanese firms evidently lack such support.

The deterioration of the Japanese political system in recent years, and its weak position in the world politics are all too evident.

We can say, ironically enough, that there is no country like Japan for respect of the principle of laissez-faire. While the US, the UK, China and Russia move on the basis of their "national interests", only Japan seems to leave everything to market fundamentalism. Restructuring of the Japanese political system is indispensable for the resurgence of Japan's position in the world economy.

4.2. The Main Cause of the Lost Decade

There is an argument that the root cause of the Lost Decade should be seen in the line of cooperation with the US, starting with the Plaza Accord. The real responsibility, however, should be sought in the government's failure to adjust policies to the changed conditions.

The appreciation of the yen rapidly ran its course in accordance with the Plaza Accord. Soon worries were spreading about the onset of depression. Then the government implemented an easy money policy (the low interest rate policy) and fiscal policy which included public works. Thanks to these measures, the Japanese economy, far from falling into depression, was able to maintain an upward trend. So far, so good.

During the same period there was a great shift in the financial structure, from indirect to direct finance (and self-finance). Due to failure to adjust to this change, the Japanese economy boiled up to the bubble phase. Above all, without implementing tight monetary policy the government allowed the bubble to run its course.

A series of drastic decisions was then implemented tightening monetary policy, such as "the Regulation of the Total Sum concerning the Property Loan", in order to arrest this process. But the government allowed the deflationary process to proceed so long that the economy plunged into depression (The government should have lifted its tight money policy earlier). Thus a series of asset deflation processes followed, starting with a sharp decline in the price of property and stock prices. Then the Japanese economy saw the collapse of the financial system. It seemed self-trapped through the inappropriate timing of economic policy.

These policy failures were further aggravated by the Structural Reformers' inconsistent policy. They argued that the economy should be left to the workings of the market as much as possible, and should be made efficient through de-regulation. So far, so good. However, they had lost sight of macroeconomic policy so there was no scope for a rational economic policy[11]. The refusal to apply fiscal policy (abnormal reaction to public works) and the implementation of de facto of deflationary policies in the deflationary phase are emblematic examples .

4.3. Chaos and Lost Confidence

Turning to the domestic side, the Japanese people as a whole seemed to shift from impatience into loss of confidence.

In the 90s Japan saw political whirlwinds. In addition, in recent years governments changed within a short period. The Democratic Party, which assembled the cabinet in October 2009, did not implement any policy measures to tackle the economic crisis that hit Japan immediately after the Lehman Shock. The main measures (the above-mentioned Child Benefit, Agricultural Individual Income Compensation, and Free Tuition for Senior High School) did not aim at tackling the economic crisis. The Democratic Party's governments have had no definite policy vision of how to manage the economy, consequently leaving it to the working of the market economy. Fiscal policy is regarded as a sort of taboo, while monetary policy (zero interest rate) has no effect in terms of recovery of the stagnant economy. The government seldom intervenes in the foreign exchange market, allowing the yen to appreciate abruptly (to dollar). In these respects the Japanese government is in sharp contrast with foreign governments (such as those of China, the US, Russia, and the EU) which set out to defend their national interests.

Consequently, even in the international economy theater Japan's presence has dwindled. The State of the Union Address by President Obama in February 2011 was emblematic, for he very often referred to Korea and China without mentioning Japan. In the sphere of foreign policy, the presence of Japan was meaningless. In the redeployment problem of the US military base in Okinawa, and the conflict of the Senkaku Islands, the government voluntarily abandoned responsibility, almost losing its raison d'être.

The firms – the driving forces of the Japanese economy - need to survive on their own in the world market, given the incompetence of the government. Japanese firms continue to be exposed to severe competition from the Korean and Chinese firms. Given the persistent shrinkage of the domestic market, they are forced to resort desperately to some global strategy. What is worrisome, as a consequence of many firms in the industries shifting their factories overseas, is the acceleration in de-industrialization.

The Japanese people seem to be losing self-confidence. Having suffered from restructuring and a rapid increase in temporary employment during the long depression, they are, psychologically and economically, in the throes of unstable conditions. Thus even if the income from savings is almost nil, they have got accustomed to abstaining from consumption.

Reflecting this social atmosphere, the young tend to be introversive. They like a quiet life, avoiding competition and showing interest no in foreign countries. Yet there is no room for this introversive attitude in today's world. Even the Japanese firms which are trying to achieve survival through global operations have a tendency not to employ more young Japanese.

Thus the Japanese economy is in a state of self-trap, finding no exit.

5. Conclusion – New Social Philosophy Required

The Japanese economy is a market economy. Yet market (or private) economy at present lacks the ability to pull itself up by the bootstraps. Even if there are innovative entrepreneurs, the present financial institutions lack the ability and will to provide themselves with the required capital. In Japan, unlike the US, venture capital market has not successfully arisen.

Moreover, the direct finance of enterprises is completely blocked because of the stagnant stock market. The key to boost the market economy should be to form a government capable of implementing shrewd and bold policies. After the private economy had been allowed to bubble, we saw it remaining stagnant. And then the government failed to come up with the necessary macroeconomic measures[11]. This should not be repeated.

"The power of the private sector, the self-adjusting mechanism of the market, economic behavior based on self-responsibility" etc.: these mottos seem to lose color in the present Japanese economy. Entrepreneurs are not necessarily beings that can be completely entrusted with the future of the Japanese economy. What they are doing at present is to reduce costs through restructuring. Although the firms might, by this means, improve the financial conditions to some degree, mass unemployment is emerging in return. It has become common practice for firms to reduce bonuses and lower wages, bringing further deflationary pressure to bear on the economy.

We suggest that both efficiency, by means of the market, and security, guaranteed by the government, should be required for the smooth working of the market economy. It is important for the economic agents to feel some degree of stability. It is an obligation for the government to work out the institutional framework, because only within a stable framework can the people engage in competition with self-confidence. Contrastingly, a society in which people are subject to uneasiness, seeing no future prospects, and dropping out as a result of competition, is not a good society. "Self-responsibility" has no meaning unless some degree of stability and safety is guaranteed. A jungle of business competition à la Hobbes is to be avoided.

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[11] This is a responsibility of macroeconomics as well.

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