CHAPTER 2

Thirty Years’ Economic Crisis

1. Introduction

This chapter chronicles Japan’s Great Stagnation during 1985–2012, from the Plaza Accord to just before the launching of Abenomics, and analyzes the economic thought of the Japanese policymakers. As seen in the following chapters, economists and policymakers are divided on the true causes of Japan’s Great Stagnation, and the debate continues in the present. Broadly speaking, there are two strands of thought, one emphasizing structural factors and the other emphasizing policy failures. The narrative in this chapter emphasizes Japan’s macroeconomic policy failures, since this perspective clarifies the fact that Japan experienced not only exogenous shocks but also a series of mistakes in macroeconomic policy, although other problems, such as the bad loans problem and policy failures in other spheres, are not neglected.¹ This perspective could also help us point out more specific problems and draw more specific lessons from Japan’s experiences than another perspective would allow.

Although the Japanese economy’s years of stagnation since the 1990s has been known as the Lost Decade or Lost Two Decades of Japan,² it is more appropriate to consider the whole episode as the “Thirty Years’ Crisis.” Admittedly, there were years when Japan performed relatively better within these 30 years; nevertheless, I believe this perspective highlights the important aspect of Japan’s Great Stagnation. It started in 1985, at the turning point of Japanese macroeconomic policy, when the Japanese government agreed with the United States and other Western governments to appreciate the yen. The appreciation of the yen was followed by the collapse of the bubble, and the slow recovery that occurred from 1990 to 1996. The period from 1997 to 2001 was the critical moment for the Japanese economy, as illustrated by the consumption tax hike, the banking crisis, and the onset of full-fledged deflation. With the emergence of Junichiro Koizumi and his
close economic advisor Heizo Takenaka, the economy began recovering from 2002 to 2007. However, the policy was reversed in 2006 when the Bank of Japan (BOJ) terminated its quantitative easing (QE) policy. The following years saw the deepening of the crisis: even though Japan was not the center of the banking and financial crisis from 2007 to 2008 and its financial sector was largely unaffected, Japan was hit hardest among the developed economies by the crisis. In the wake of the crisis, the Democratic Party of Japan (DPJ) succeeded in ousting the governing Liberal Democratic Party (LDP) in September 2009, but the DPJ failed to deal with deflation and stagnation. Then, in November 2012, came the new economic policy package known as Abenomics. It is still uncertain that Abenomics can deliver robust and sustainable growth: early signs were promising, but the economy may plunge back to a recession with the consumption tax hike that is effective as of April 2014.

These 30 years have been one of the most changeable periods in politics. The ever-powerful LDP, which had dominated Japanese politics from 1955 onward, lost its power in August 1993, when a number of its own members abandoned it to form a new party and a coalition government with other parties. The LDP returned to power with the help of the Japan Socialist Party (JSP) in 1994. Electoral reform was implemented in the same year. The LDP remained in power until 2009, yet it was not alone: this was and still is a period of coalition governments. In August 2009, the DPJ finally won the general election, but it lost in December 2012. I do not delve into the dynamics of political economy during the period, yet suffice it to say that given the public expectations for a revival of the economy, the popularity and survival of the government depends on economic performance.

The chapter is organized as follows. Section II describes the 1985 Plaza Accord and its immediate aftermath. This set in motion the vicious spiral of the policy idea trap, with one mistake leading to another. Section III turns to the years after the bursting of the bubble. The government’s responses were slow, with policymakers doing “too late, too little,” especially in addressing asset price deflation and the resolving the bad loans problem. Section IV discusses the years from 1996 to 2001, the worst years of the Great Stagnation. The government contracted fiscal policy, the full-scale financial crisis broke out, and deflation rooted in. The crisis brought in new people, Junnichiro Koizumi and Heizo Takenaka, who are the topic of Section V. The Koizumi-Takenaka economic policy was controversial, but it finally solved the bad loans problem, and the economy recovered. However, the crisis was not over. Section VI deals with the period from 2006 to 2012, when a series of shocks and macroeconomic policy mistakes were repeated. Section VII concludes with a summary assessment of the economic ideas of the policymakers.