THE CAUSES OF JAPAN'S LOST DECADE AND ITS EFFECTS ON MONETARY AND FISCAL POLICY

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Introduction

The Lost Decade of Japan was a period of ten years in which the Japanese economy contracted and then entered a period of long-term stagnation.[1] It was caused by the sudden bursting of an economic bubble which centered around real estate prices; this sudden contraction led to a decline in Japanese national income and standards of living, as well as a stock market crash.[2] The resulting stagnation left Japan with a weak economy. The legacy of this period is still felt by the country, which continues grappling with stagnant GDP growth, high debt, and deflation.[3]

Background

In the late 1980s, the Japanese economy was undergoing an asset price bubble unlike anything the country had seen before. The extent of this bubble was so great that it was estimated that the Japanese Imperial Palace was worth more than the entirety of the real estate in California.[4] Japanese banks were famous for their lax lending standards, including the issuance of risky or subprime loans. Economist Paul Krugman described this policy as helping to “inflate the bubble economy to grotesque proportions.”[5] The collapse of this bubble in 1992 was a sudden and severe reversal of fortune for the country, and the resulting recession was “no ordinary recession.”[6] The collapse of asset prices left Japanese individuals and businesses with high levels of debt and little in the way of assets. This caused a shock to aggregate demand as

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[1] Fumio Hayashi and Edward C. Prescott, “The 1990s in Japan: A Lost Decade,” January 2000, https://doi.org/10.21034/wp.607.
[2] Shiller, Robert J., Fumiko Kon-Ya, and Yoshiro Tsutsui. "Why Did the Nikkei Crash? Expanding the Scope of Expectations Data Collection." *The Review of Economics and Statistics* 78, no. 1 (1996): 156-64. doi:10.2307/2109855.
[3] Barry Nielsen, “The Lost Decade: Lessons From Japan's Real Estate Crisis,” Investopedia (Investopedia, September 16, 2020)
[4] Kozo Yamamura, *Too Much Stuff: Capitalism in Crisis* (Bristol: Policy Press, 2018), p. 106.
[5] Paul R. Krugman, *The Return of Depression Economics and the Crisis of 2008* (New York: W.W. Norton & Co., 2009).
[6] Richard C Koo, “The World in Balance Sheet Recession: What Post-2008 West Can Learn from Japan 1990-2005,” accessed April 15, 2021, https://fbe.unimelb.edu.au/__data/assets/pdf_file/0020/2620361/Finch2012.pdf.

these entities were forced to cut back on consumption in order to manage their debts. In the decade following the collapse, Japan's GDP was effectively stagnant, increasing by 1.14% per annum. This was a sharp decline from the booming 1980s, which saw GDP growth peaking at 6.79% in 1988.[7]

The Japanese Government and the Bank of Japan both took action following the asset bubble collapse to try and mitigate the demand shock and resulting recession. The monetary and fiscal policies enacted during the Lost Decade were unable to restimulate the Japanese economy, and policymakers are grappling with the issue to this day. However, the Lost Decade did have significant effects on the ways monetary and fiscal policy are conducted, and there are lessons to be learned from the period.

The Lost Decade's Effects on Monetary Policy

The collapse of Japan's asset price bubble and the resulting recession demanded immediate action from the Bank of Japan, the country's central bank. In June of 1991, the Japanese discount rate was at 6%.[8] The central bank had been raising interest rates since March of 1989, when the discount rate was at 2.5%. In fact, it has been postulated that the Bank of Japan may have triggered the bursting of the asset bubble with their hawkish monetary policy, which was implemented to reign in the "overheating" economy. Immediately following the crisis, the Bank of Japan reversed course and began to cut interest rates; by October 1995, interest rates sat at 0.5%, a 92% drop from their high point in 1991.[9]

However, the sharp cuts in interest rates had little effect in stimulating the ailing Japanese economy. The country's high levels of debt meant that the public was more concerned with

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[7] "GDP Growth (Annual %) - Japan." Data. World Bank. Accessed April 16, 2021. https://data.worldbank.org/indicator/NY.GDP.MKTP.KD.ZG?locations=JP.
[8] "FRED - Discount Rate for Japan, 1955 to 2015," FRED, accessed April 16, 2021, https://fred.stlouisfed.org/graph/?id=IRLTLT01JPM156N%2CINTDSRJPM193N%2C.
[9] "FRED - Discount Rate for Japan, 1955 to 2015," FRED, accessed April 16, 2021, https://fred.stlouisfed.org/graph/?id=IRLTLT01JPM156N%2CINTDSRJPM193N%2C.

repaying this debt than it was in increasing consumption. In the words of the economist Richard C. Koo, "people with negative equity are not interested in increasing borrowing at any interest rate."[10] These factors meant that simply cutting interest rates back to near zero was no longer enough to meaningfully stimulate the Japanese economy out of its slump. Since it is impossible to cut interest rates to below zero percent, the Japanese economy entered a *liquidity trap*. The Bank of Japan had used its most powerful tool to its limits and could not use it further. Today, the discount rate in Japan is -0.1% -- the country has finally entered negative territory. The liquidity trap continues to hold Japan's economy hostage -- the central bank is powerless to raise interest rates, as any attempt to do so would have negative effects on the macroeconomy.

The Bank of Japan also took the step of cutting the reserve requirement ratio for Japanese banks from 0.725% in the first half of 1991 to 0.425% by the end of that same year (see graph below.)[11] This was likely done to increase the money multiplier effect, increasing the effect of the central bank's monetary policy on the size of the money supply. Recall that the money multiplier is the *inverse* of the reserve requirement ratio: $m = \frac{1}{RR}$. Therefore, the effect of monetary policy is increased as reserve requirements are decreased, explaining this action by the Bank of Japan; $m$was increased from 137.9 to 235.3 ($\frac{1}{0.725\%}$ compared to $\frac{1}{0.425\%}$). With interest rates near zero, the Bank needed to do what it could to maximize the expansionary effects of its policies on the sluggish Japanese economy.

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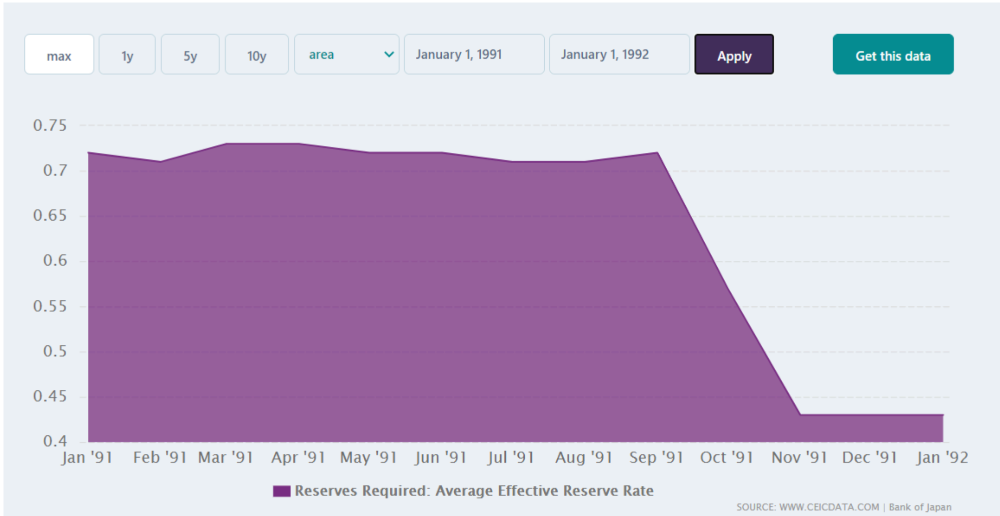
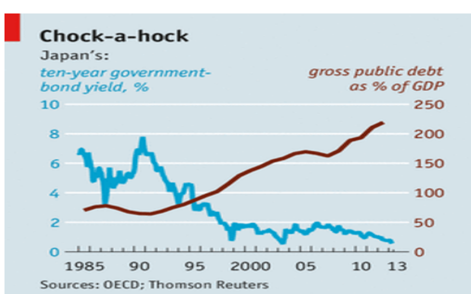
[10] Richard C Koo, "The World in Balance Sheet Recession: What Post-2008 West Can Learn from Japan 1990-2005," accessed April 15, 2021, https://fbe.unimelb.edu.au/__data/assets/pdf_file/0020/2620361/Finch2012.pdf.

[11] "Japan Reserve Requirement Ratio," CEICDATA, accessed April 15, 2021, https://www.ceicdata.com/en/indicator/japan/reserve-requirement-ratio.



The Lost Decade's Effects on Fiscal Policy

While the Bank of Japan cut interest rates and implemented an expansionary monetary policy, the Japanese government also took action, initiating economic stimulus programs to make up for the shortfall in demand, and to try and bolster the country's GDP. The 1990s saw the Japanese government spending more than 100 trillion Yen[12] -- more than $800 billion (1992 USD). This did not increase demand as the government had hoped, and the expensive programs began to drive the country deeper into debt. By 2014, Japan's debt exceeded 240% of its GDP, making it the most indebted country in the world when measured by this metric.[13]



Source: The Economist[14]

[12] International Monetary Fund. Statistics Dept., "International Financial Statistics Yearbook, 2001," IMF, accessed April 16, 2021, https://www.imf.org/en/Publications/International-Financial-Statistics/Issues/2016/12/30/International-Financial-Statistics-Yearbook-2001-15154.
[13] "Don't Mention the Debt," The Economist (The Economist Newspaper, May 4, 2013), https://www.economist.com/finance-and-economics/2013/05/04/dont-mention-the-debt.
[14] "Don't Mention the Debt," The Economist (The Economist Newspaper, May 4, 2013), https://www.economist.com/finance-and-economics/2013/05/04/dont-mention-the-debt.

Intervention by the government in order to stimulate spending and consumption during times of recession is a well-known tenet of Keynesian economics,[15] but in Japan's case the government's enormous fiscal stimulus was ineffective. The program was unable to reverse the negative shock to demand, and the government has reached the limits of what it can borrow in order to initiate stimulus. There is also the problem of Ricardian Equivalence, where Japanese consumers take the government's finances into account when saving, investing, or consuming their capital. The stimulus may have been ineffective because of this; as short term income increases because of tax cuts and stimulus, long term income declines because the government will eventually raise taxes to pay off the debt incurred by the stimulus program.[16] In fact, this is what happened in Japan; the country increased its consumption tax from 5% to 10% from 2013 to 2015 in order to balance its budget -- or at least make the attempt.[17] The negative effects of these taxes on demand will further hamstring the Japanese recovery.

Conclusion: The Legacy of the Lost Decade

The Lost Decade has influenced and affected the Japanese economy since 1991; it would be more apt to call this period the *Lost Decades*, as it certainly lasted more than ten years. To this day, the country struggles with a sluggish economy, fighting deflationary pressure, stagnation, a liquidity trap, and high government debt levels.

The Lost Decade is a case study of how economic stagnation can affect an advanced economy. Japan is not a developing country. It has an advanced economy -- the third largest in

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[15] Investopedia Staff, "Keynesian Economics Definition," Investopedia (Investopedia, October 26, 2020), https://www.investopedia.com/terms/k/keynesianeconomics.asp#:~:text=The%20intervention%20of%20government%20in,underemployment%2C%20and%20low%20economic%20demand.&text=Short%2Dterm%20demand%20increases%20initiated,employment%20and%20demand%20for%20services.

[16] Jim Chappelow, "Ricardian Equivalence Definition," Investopedia (Investopedia, December 14, 2020), https://www.investopedia.com/terms/r/ricardianequivalence.asp.

[17] "Don't Mention the Debt," The Economist (The Economist Newspaper, May 4, 2013), https://www.economist.com/finance-and-economics/2013/05/04/dont-mention-the-debt.

the world by nominal GDP[18] -- and the country is on the cutting edge of innovation and development. It is a member of the OECD. For this reason, understanding the Lost Decade is of great importance. The world's other developed countries can learn from the Japanese experience, and safeguard their economies against a similar fate.

[18] "GDP by Country," Worldometer, accessed February 18, 2021

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