Japan Economic Recovery from the lost Decade: Towards Stability or Volatility

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I. Introduction
1. The 1980s marked a decade of Japan’s excellent economic performance, with an average Gross Domestic Product (GDP) growth rate of 3.9%. However, her fortune was reversed dramatically in the 1990s during which Japan sunk into a deep and long recession which is commonly described as the Lost Decade. Today, we see a weak recovery of Japan’s economy out of this long recession.

2. The objective of this paper is to apply macroeconomic models to explain why Japan had experienced a severe downturn and analyze the failure of monetary and fiscal policies to reverse the recession. Looking forward, this paper also proposes possible policy solutions to sustain Japan’s current weak recovery.

II. Japan’s Lost Decade
1980’s: A Decade of Excellent Economic Performance
3. Prior to 1989, Japan’s economic performance was impressive, recording real GDP growth rate of 3.9% annually. (see Figure 1).

4. The booming economy led to an appreciation of the Japanese Yen against US dollar in the late 1980’s which resulted in higher prices of domestic goods in the foreign market and worsened the current account. To maintain competitiveness of domestic goods and services, the Japanese government injected money in the market to depreciate the currency\(^1\) and the economy grew rapidly\(^2\).

1990’s, The Lost Decade
5. The equity and housing bubble led to widespread speculation of rising prices. When the bubble was pricked, these prices decreased tremendously (see Figure 2). This drastic fall in asset prices brought about subsequent effects beyond the financial and property sectors. Firms which had speculated heavily in the housing market had no capital for other investments and were saddled with bank loans, this in turn largely reduced capital investment in Japan. Similarly, consumers with lower relative purchasing power were spending significantly less. As a result of crashing housing prices, loans issued by banks to speculating firms and consumers became bad debts. Facing liquidity

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\(^1\) interest rate was reduced from 3% to 2.5% in 1987 at the peak of bubble.

\(^2\) By \(Y = C + I + G + CA\) (an increase in CA further boosted Y. Together with increase in prices of equity and property, the economy was overheated.)
problems, banks were reluctant to issue more loans to generate investment or consumption. During the decade (1991-2000), the average real GDP growth slumped to 0.91 percent.

Ineffective Monetary and Fiscal Policies

6. The monetary policy expansion in the late 1980’s led to the decline of interest rates towards zero (see Figure 3). At the initial stage of the recession, Japan tried an expansionary monetary policy with hopes of generating higher output and recovering economically. Theoretically, the increase in money supply would shift the AA curve outwards and generates a higher output. However, Japan faced a different economic situation which was known as a liquidity trap.

7. A liquidity trap occurs when nominal interest rates fall to zero. An expansionary money supply will not encourage people to hold more liquid assets as people are indifferent to holding money or interest bearing assets. As seen in Figure 4, Japan faced AA1, which reflects a liquidity trap. An expansionary monetary policy would shift AA1 to AA2. However, due to the initial flat AA curve, the shift did not result in any increase in output, Y1. To get out of the trap, if the permanent increase in money supply raises the expectation on future inflation and resulting in the market expecting a depreciation of the Japanese yen, AA1 will shift to AA3 and output will increase from Y1 to Y2. However, this did not happen in Japan. The Bank of Japan could not increase people’s expectations of inflation so as to encourage people to increase current consumption. Japanese firms and consumers remained very pessimistic over their future economic situation.

8. In addition to monetary policies, the Japanese government adopted an expansionary fiscal policy through tax cuts and increased government spending. From 1990 to 2000, the total value of outstanding government bonds increased by more than 120%. Despite the bold moves to expand the economy fiscally, the magnitude of the impact due to the fiscal policy was assessed to be very small initially as seen from Figure 4 (shift of DD1 to DD2). Towards the later part of the recession, such fiscal expansion was ineffective because there were widespread concerns of Japan’s ballooning public debt and huge government deficit.

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3 There are different literature assessing the magnitude of impact and there were contrasting views amongst economists on whether the expansionary fiscal policy actually increase output (Saxonhouse and Stern, 2002)
III. Recovery from Lost Decade

9. After almost more than a decade of low GDP growth, Japan is still facing a mixed recovery, shown by a positive growth of 1.53% (from 2001 to 2007) and a relatively stable exchange rate. Japan continues to face deflation and a very low interest rate although it is now gradually rising above zero at an average of 0.24%. During this recovery period, there was a relatively slight depreciation of the Japanese yen compared to the Lost Decade. While this depreciation has a role to play in improving Japan’s current account (CA), the larger increase of $33 billion (32%) in CA was more dramatic due to large incomes of net factor payments as gains from investment abroad were more significant comparatively since the returns on Japanese assets were at almost zero rates during the Lost Decade.

<table>
<thead>
<tr>
<th>Average</th>
<th>Period</th>
</tr>
</thead>
<tbody>
<tr>
<td>Growth GDP (%/yr)</td>
<td>3.89</td>
</tr>
<tr>
<td>Trade Balance (Billions USD)</td>
<td>54.15</td>
</tr>
<tr>
<td>Export</td>
<td>195.39</td>
</tr>
<tr>
<td>Import</td>
<td>141.24</td>
</tr>
<tr>
<td>Inflation (%/yr)</td>
<td>2.56</td>
</tr>
<tr>
<td>Exchange Rate (Yen/USD)</td>
<td>195.00</td>
</tr>
<tr>
<td>Interest Rate (%/yr)</td>
<td>4.68</td>
</tr>
</tbody>
</table>

IV. Policy Proposals: Sustaining Economic Recovery

10. Japan is now on its very gradual economic recovery from the Lost Decade. During the Lost Decade, Japan implemented aggressive monetary and fiscal policies to move it out of the recession without much success. Has this been changed now?

Monetary Policy

11. Today, from statistics, we observe that the interest rate is now gradually rising above zero (increasing from 0.1% during the Lost Decade to 0.4% in 2006 and 0.75% in 2007) though it is still comparatively much lower than US or EU interest rates. The liquidity trap faced by Japan is less apparent now, given the slight rise in interest rate. The increase in the share prices during the recovery period has also somewhat increased the liquidity positions of Japanese banks. The banking reforms initiated during the Lost Decade were also taking shape.
12. The money demand function is gradually improving as optimism amongst businesses picks up once again on hopes of economic recovery and stable political environment (especially during PM Koizumi’s leadership). Foreign investments may likely to increase given that the poorer economic outlook of the US and EU. This poorer relative outlook in US and EU compared to Japan may attract investments to flow into Japan away from US and EU.

13. Prior to US subprime crisis, based on the consumer survey conducted by Bank of Japan, the general public was generally optimistic with positive outlook for the future economic situation (i.e. wage rise) and indicated an increase in consumption and positive outlook for the recovery. However this optimism is eroding due to the current US subprime fiasco. The Japanese are anticipating general price inflation and would be increasing their spending in the near future. Another survey by Japan’s Ministry of Finance Business Optimism Survey conducted on Japanese firms indicated an increase in business sentiment. However, similar to consumer’s confidence level, the sentiment is decreasing in the current unstable global economic situation. (see Table 2).

Table 2: Japan’s Business Sentiment Index (Source: Japan Ministry of Finance)

<table>
<thead>
<tr>
<th>Period</th>
<th>Q1Y06</th>
<th>Q2Y06</th>
<th>Q3Y06</th>
<th>Q4Y06</th>
<th>Q1Y07</th>
<th>Q2Y07</th>
<th>Q3Y07</th>
<th>Q4Y07</th>
<th>Q1Y08</th>
<th>Q2Y08</th>
</tr>
</thead>
<tbody>
<tr>
<td>% change in Business Sentiment Index</td>
<td>9.7</td>
<td>7.5</td>
<td>11.3</td>
<td>12</td>
<td>7.9</td>
<td>9.9</td>
<td>11.5</td>
<td>8.6</td>
<td>2.1</td>
<td>6.6</td>
</tr>
</tbody>
</table>

14. Unlike the past when there is no expectation of future inflation, riding along this global wave of rising oil, food and commodities prices, Japan being an importer of oil and related products is likely to face inflationary pressures. (see Table 3). As discussed in the earlier paragraph, with an expectation of inflation, consumers may increase their current consumption instead of postponing for the future, this will in turn generate GDP growth.

Table 3: Japan’s Consumer Price Index (Source: Japan Ministry of Internal Affairs and Communication, 2005=100)

<table>
<thead>
<tr>
<th>Period</th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
</tr>
</thead>
<tbody>
<tr>
<td>CPI</td>
<td>102.5</td>
<td>101.5</td>
<td>100.6</td>
<td>100.3</td>
<td>100.3</td>
<td>100.0</td>
<td>100.3</td>
<td>100.3</td>
</tr>
<tr>
<td>Inflation</td>
<td>-0.71</td>
<td>-0.76</td>
<td>-0.90</td>
<td>-0.25</td>
<td>-0.01</td>
<td>-0.27</td>
<td>0.24</td>
<td>0.06</td>
</tr>
</tbody>
</table>

15. Judging optimistically from the above indicators, we propose a slight expansionary monetary policy. At a relatively low interest rate, there is room for increase in money supply, but a cautious approach needs to be taken as a drastic increase money supply may undo the current slight increase in interest rate (i.e. should not shift back to zero). An increase in money supply will then increase output (i.e. economic growth).

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4 Results of the 32nd Opinion Survey on the General Public's Views & Behavior, Public Relation Department, BoJ, Feb 6,2008
5 A survey conducted on Japanese firms with capital above $1 billion yen on what is their business outlook for the future quarters.
16. If had not for the current financial instability, this policy is likely to achieve greater success. Nonetheless, there are limitations given the current turmoil. This is because the model will fail if the consumer optimism continues to erode amidst the US subprime uncertainty. In addition, the increase in money supply may be counter balanced by external factors such as a larger depreciation of US dollar relative to yen (i.e. an appreciation of yen relative to dollar) due to the US market itself. Politically, the current vacant position for Chief of Bank of Japan is adding to this uncertainty.

**Fiscal Policies**

17. Shifting to fiscal policy, there is little room for fiscal policy to increase output compared to monetary policies. During the Lost Decade, much has been done to increase output using fiscal policy which resulted in a very huge government budget deficit. As at 2007, the government budget deficits amounted to 29.7 trillion yen (see Figure 5) and government debt amounted to 148% of GDP. Based on Japan’s MOF current policy stance, the government is now committed to reduce this fiscal deficit through reducing expenditure gradually and promoting fiscal discipline in government spending programs.

18. One good sign is the narrowing of this deficit due to increased tax revenue from the recovering economy. The decreasing reliance on traditional export markets such as the US and the increased trade volume with emerging economies such as China and India has diversified Japan’s trade patterns. The growing appetite for Japanese imports by the Chinese has boosted Japan’s aggregate demand. But nonetheless, Japan faces tremendous pressure from her rapidly ageing population which puts a strain on the fiscal position due to increased social welfare spending. While government investment has increased, the extremely low private investment during the Lost Decade may reduce economic growth in the longer term.

![Japan Govt Budget Expenditure, Revenue and Deficit](image)

**V. Conclusion**

19. Japan’s economic recovery is mixed. In particular with the current global economic uncertainty over US sub-prime woes, Japan’s economic recovery remains a difficult path. As seen from current statistics and macroeconomic analysis, there is no one-size-fits-all remedy for Japan’s own unique economic situations.
Reference


