Japan's Great Recession: Overview and Policy Challenges

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요 약

Contrary to popular perception, Japan's Great Recession was not an uninterrupted period of economic decline. To place its history in better perspective, therefore, this study divides the two-decade long economic stagnation into five successive waves of recession. Based on the analysis of these past five waves, this study identifies policy challenges that Japan faces to break fully from its long-running Great Recession and get on the sustainable growth path. This study also takes note of additional challenges in the current round of economic recovery that mainly result from radical macroeconomic policies pursued in the current Abe administration.

Keywords: Japan, Great Recession, Economic Growth, Policy Challenges

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Ⅰ. Introduction

There has been a stream of encouraging signs from the Japanese economy suggesting economic recovery is underway in the country. Prime Minister Shinzo Abe rightly placed the priority of his first cabinet on reviving the economy as soon as his Liberal Democratic Party (LDP) won a landslide victory in the general election of December 2012. He pursued a drastic regime change at the Bank of Japan as well as large fiscal spending to end deflation and stimulate growth. Various macroeconomic indicators currently show that deflation is finally under control and growth is picking up in the country.

As a result, there is growing excitement, inside and outside of Japan, about the possibility that the country is at last poised for getting out of its two-decade long "Great Recession". However, this study cautions that it remains to be seen whether this is really the case. It should be noted that Japan's Great Recession, contrary to popular perception, was not an uninterrupted period of economic decline. In the past couple of decades, the Japanese economy repeatedly showed the sign of recovery for a while before it quickly slipped back into another recession. Accordingly, this study outlines Japan's Great Recession by dividing the two-decade long economic stagnation into five successive waves of recession. The repeated crushing of an emerging recovery in each of the five waves makes it clear that the current recovery is far from guaranteeing the exit from the Great Recession.

Subsequently, this study attempts to identify policy challenges that Japan faces to break fully from the Great Recession and get on the sustainable growth path. In the existing literature, Adam Posen (1998,

2004) argues that Japan's long-running economic slump was the result of a series of fiscal, financial, and monetary policy mistakes that prematurely cut off the natural tendencies to recovery. Some other studies (e.g., Hayashi and Prescott, 2002; Fukao and Miyagawa 2004, Lee 2011) point to slow total factor productivity growth as a main cause of the long-term slump since total factor productivity growth represents the part of economic growth that would be sustainable and hence of long-term significance. On the other hand, McDonald (2003) suggests that demographic change in Japan served as an important cause of the country's protracted economic stagnation by weakening aggregate demand. Japan has the most rapidly aging population among industrial countries, accompanied by rapidly falling fertility rates.

Syed et al. (2009) point out that Japan's weak banking sector left its economy highly vulnerable to external adverse shocks. In this regard, this study argues that nonperforming loans in the banking sector are importantly behind the collapse of short-lived recoveries during the Great Recession. Turning to fiscal spending, Krugman (2009) argues that fiscal stimulus was a more effective means of providing liquidity into the Japanese economy than monetary expansion in the past couple of decades because the economy was caught in the so-called liquidity trap most of the time. However, this study notes Japan's fiscal stimulus generated only a series of temporary recoveries that tended to be quickly reversed after each round of fiscal spending became complete, mainly because of relatively low fiscal multipliers. The country's weak private domestic demand and political system are also viewed to have significantly contributed to prolonging the economic slump.

While the policy challenges listed above are still relevant to today's

efforts to achieve a sustainable recovery, this study also takes note of additional challenges in the current round of economic recovery. These additional challenges mainly result from radical macroeconomic policies that have been pursued since the start of the Abe administration. For example, the unconventional easing program adopted by the Bank of Japan has helped to usher in the trend of rising prices, but it also carries increasing risks associated with the program's eventual unwinding. In addition, the aggressive fiscal spending under the watch of the Abe administration has placed additional pressure on public debt that already exceeds the level twice the country's total gross domestic product (GDP). If the rapid increase in debt-service burden creates a vicious circle of growing public debt, there is a danger that the country's debt sustainability is called into question.

The rest of the paper is organized as follows. Section II provides an overview of Japan's Great Recession by dividing the entire period into five successive waves of recession. Section III discusses possible causes of the Great Recession with the aim of identifying policy challenges in getting the country back on the sustainable growth path. Section IV concludes with the discussion of additional challenges posed by recent macroeconomic policies under the Abe administration.

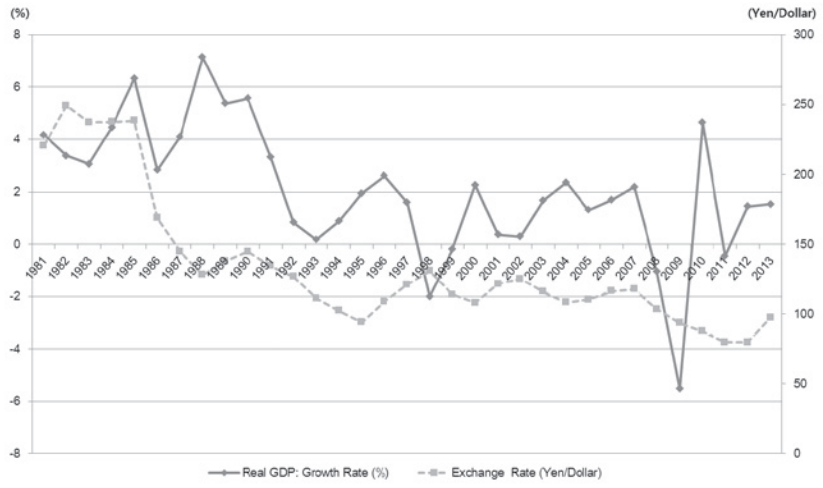
II. Great Recession: Overview

1. Prelude

The story of Japan's Great Recession began with the Plaza Accord of

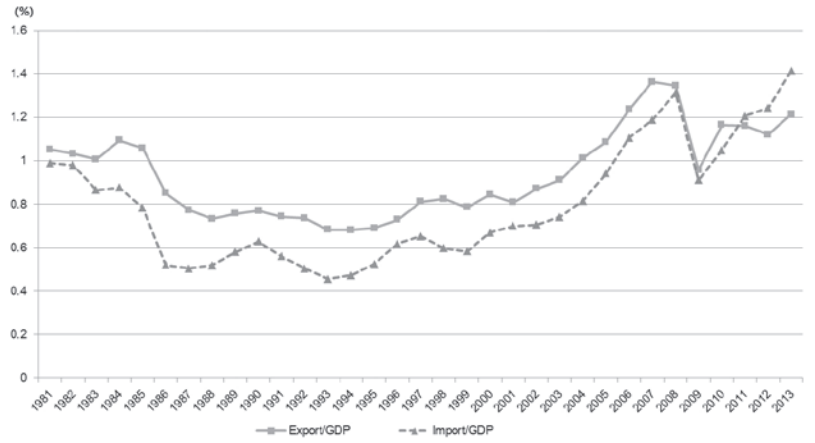
1985 that led to a sharp appreciation of the Japanese yen over the next four years. The average annual value of the yen rose from 238.6 yen per dollar in 1985 to 128.1 yen per dollar in 1988. It was the rate of appreciation that was close to 50 percent! Japanese exporters responded to the rapid appreciation of their home currency in various ways, including diversifying their businesses, strengthening research and development (R&D), relocating production facilities abroad, and saving labor costs through the increased use of contract workers. Nonetheless, the country's exports as a share of GDP suffered a sharp fall in 1986, and the growth rate of real GDP in 1986 was cut by more than one-half compared with the previous year's growth rate. Figure 1 shows the trend of Japan's real GDP growth rates and exchange rates over 1981-2013. Figure 2 presents Japan's exports and imports as a share of GDP.

〈Figure 1〉 Real GDP Growth Rates and Exchange Rates in Japan



Note: Exchange rates are annual averages of yen per US dollar.
Source: OECD.Stat

〈Figure 2〉 Exports and Imports (% of GDP) in Japan



Source: OECD.Stat

In response to an economic downturn following the Plaza Accord, the Bank of Japan pursued aggressive monetary expansion through a series of policy rate cuts. The benchmark interest rate was lowered five times from 5.0 percent in 1985 to 2.5 percent in 1987. Such aggressive monetary expansion was possible because inflation stayed low and stable largely due to falling import prices under the sharply appreciating yen. While consumer prices grew on average 2.1 percent per year for three years before the Plaza Accord, they grew only about 0.5 percent per year during 1986-1988. The environment of low interest rates stimulated consumption and investment spending in the country. In fact, robust consumption and investment spending largely offset a decline in net exports due to currency appreciation, and generated economic growth even stronger than the growth before the Plaza Accord.

An economic boom fueled by low interest rates bred overoptimistic prospects for the Japanese economy. There was widespread

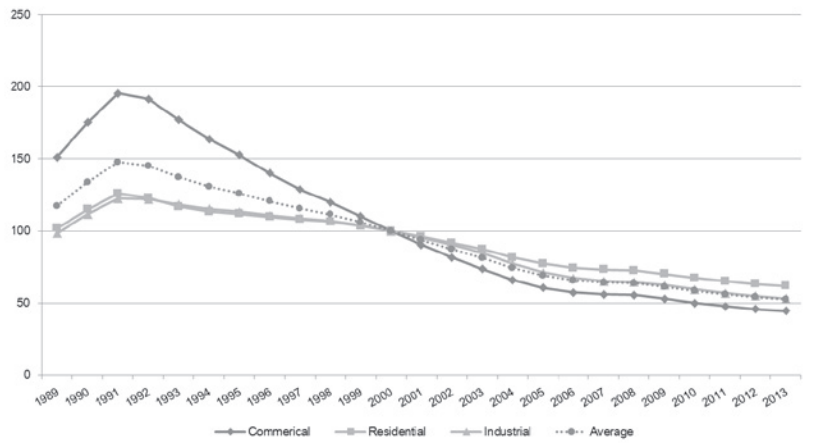
expectation that Japan would eventually replace the United States to become the largest economy by maintaining its pace of economic growth. Without doubt, over-optimism encouraged overinvestment. Furthermore, lax prudential regulation coupled with loose monetary conditions helped overinvestment to be funded with bank loans. As financial sector liberalization progressed in the country from the 1980s, large corporations that were traditionally dependent upon bank loans increasingly turned to capital markets for direct funding. This trend obviously undermined bank profitability, and created a moral hazard incentive among banks to accept higher risks. Against the backdrop of improper prudential supervision, rapid monetary expansion allowed Japanese banks to extend loans excessively to small and medium-sized enterprises (SMEs), households, and real estate sectors. The loans to SMEs and households accounted for around 50 percent of total bank loans in 1985, but their portion sharply increased to more than 70 percent by 1990.

The resulting credit boom eventually created substantial asset bubbles through a vicious cycle. That is, the existing credit boom raised asset prices rapidly, and higher asset prices in turn worked to further intensify the existing boom by increasing the value of the collateral. In particular, government policies for balanced regional development played a key role in spreading the real estate bubble all over the country. In 1987, for example, the Japanese government announced wide-ranging plans to lessen the disproportionate concentration of economic power in Tokyo and encourage regional economic growth, including the relocations of government agencies and promotion of new industrial clusters across the country.

2. First Wave: Bursting of Bubbles

With the buildup of bubbles in the real estate market, house prices in Japan soared. In response to a rapid escalation of house prices, the Bank of Japan sharply raised policy rates from 2.5 percent to 6 percent between April 1989 and July 1990. The Japanese government also introduced various measures to limit real estate related loans that effectively stopped fresh loans to the construction and real estate sectors. Following interest rate hikes and tougher regulations on bank loans, stock prices began to fall sharply. The Nikkei index was cut by almost one-half during the first three quarters of 1990. Land prices also began to slide from 1992. Figure 3 shows the trend of the urban land price index of the Japan Real Estate Institute (JREI) over 1989-2013.

〈Figure 3〉 Urban Land Price Index (2000=1) in Japan



Note: Index as of the end of March each year.
Source: Japan Real Estate Institute

The Bank of Japan quickly responded to falling real estate prices by lowering the policy rate. The policy rate that stood at 6.0 percent in August 1991 was cut to near zero by 1995. However, interest rate cuts by the Bank of Japan failed to arrest the decline in real estate prices mainly because the expectations of a continuous fall in real estate prices had already set in and been firmly in place. In fact, land prices have continued to decline to date as shown in Figure 3. In terms of the average of commercial, residential, and industrial land prices, the land price index at the end of September 2013 stood at only about 40 percent of the level at the end of March 1990.

Falling real estate prices created a vicious circle of nonperforming loans (NPLs). That is, falling real estate prices led to a drop in collateral value, to an increase in nonperforming loans, to weaker financial health of commercial banks, to a decrease in fresh loans or existing loans rolled over, to a rise in corporate bankruptcies, and to additional nonperforming loans. According to the Financial Supervisory Agency, risk management loans of city banks, long-term credit banks and trust banks increased more than 70 percent between 1992 and 1995, reaching 21.9 trillion yen in 1995. [1)]

In addition to interest rate cuts by the Bank of Japan, the Japanese government also pursued aggressive fiscal policy to reverse the sharp economic downturn following the collapse of the bubble. There were altogether six fiscal stimulus packages totaling 65.5 trillion yen during 1992-1995. From 1994, the Japanese economy began to show the sign

1) Risk management loans include loans to borrowers in legal bankruptcy, past due loans and restructured loans.

of recovery even though its speed was slower than expected. As shown in Figure 1, the growth rate of real GDP only gradually increased from 0.2 percent in 1993 to 0.9 percent in 1994 and to 1.9 percent in 1995. The economic recovery was slow despite highly expansionary macroeconomic policies, partly due to the strong yen. The yen to dollar exchange rate continued to slide until it fell below 80 yen per dollar in April 1995, prompting a manufacturing exodus in which Japanese companies shifted production abroad. This trend of production base relocation was believed to hamper the effectiveness of expansionary macroeconomic policies by depressing domestic investment and consumption. On the other hand, successive fiscal stimulus packages began to deteriorate the country's fiscal position as tax revenues continued to fall due to the slow economy. The ratio of public debt to GDP exceeded 90 percent in 1995 after increasing by almost 25 percentage points between 1991 and 1995.

3. Second Wave: Asian Crisis

Japan's economic growth became noticeably stronger in 1996 as investment in the construction sector grew 11 percent following the Kobe earthquake of the previous year. Believing that economic recovery was firmly in place, the Hashimoto administration raised the consumption tax rate from 3 percent to 5 percent to address growing public debt.[2] However, the fiscal consolidation effort quickly began to

2) In addition, a temporary income tax cut was lifted, and social security premiums were raised.

cool down the economy, and the subsequent Asian crisis transformed this slowdown into a full-blown crisis. The Asian crisis unmasked the health of the Japanese financial system that had been saddled with large NPLs, pushing the country close to a financial meltdown. Japan's financial sector suffered a series of large-scale bankruptcies, including the bankruptcies of Sanyo Securrities, the Hokkaido Takushoku Bank, and Yamaichi Securities.

The financial crisis created a severe credit crunch. A sharp credit contraction, combined with deflation, led to the negative growth of real GDP in both 1998 and 1999. In the midst of financial crisis, the Japanese government chose to inject capital into the financial system and expand fiscal stimulus without tackling the NPL problem. This approach inevitably delayed the exit of failed companies and worsened the country's fiscal position while failing to prevent the economy from contracting for two years in a row during 1998-1999. In 2000, however, the growth rate of real GDP shot up to 2.3 percent, largely driven by the global information technology (IT) boom. Japan's export and private fixed investment registered an unusually high pace of growth, respectively growing 8.5 percent and 7.9 percent, in that year. The market entry of new firms also substantially increased in the country.

4. Third Wave: Birth of Koizumi Administration

Japan's economic boom in 2000 was short-lived as the global IT bubble began to collapse in the year. The growth rate of real GDP fell sharply to 0.35 percent, and the rate of unemployment reached 5 percent in 2001. Prime Minister Koizumi began his term amidst this

sharp economic downturn. The economy suffered a further slowdown in 2002 with the growth rate of real GDP down from an already low level of 0.35 percent in 2001 to 0.29 percent in 2002. The rate of unemployment also rose from 5 percent to 5.4 percent between 2001 and 2002. Furthermore, deflation was plaguing the economy as evidenced by the negative growth of the consumer price index (CPI) in 2002. The trends of Japan's unemployment rates and inflation rates for the period 1981-2013 are presented respectively in Figures 4 and 5.

Given the economy still adrift after the decade-long economic slump, the Koizumi administration was able to embark on a wide range of reform measures with strong public support. First, his administration pursued public sector reform by shrinking the number of government ministries and the size of the government wage bill. The administration also implemented a wide range of structural reform measures with the goal of stimulating business investment. Tax exempts were offered for investment income, and the establishment of limited liability partnerships

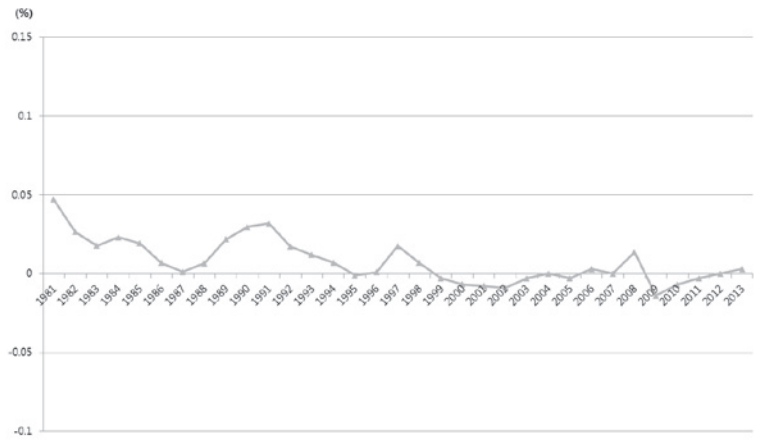
〈Figure 4〉 Unemployment Rates in Japan

Source: OECD.Stat

was allowed to encourage start-ups and promote mergers and acquisitions (M&As). There were also a series of deregulation measures to make labor market more flexible and remove restrictions on business investment in large cities.

As the administration successfully resolved NPL problems, the country's financial and corporate sectors were gradually on a stronger footing. Subsequently, the Japanese economy began to show the sign of a relatively enduring recovery aided by strong private domestic demand. A favorable external environment such as robust export demand from China also helped a more durable recovery to take hold. The average growth rate of real GDP during 2003-2007 reached 2 percent per year. This sustained growth fueled widespread optimism in Japan that the country had got out of a long tunnel of economic stagnation at last. However, this optimism started to wear thin as subsequent LDP administrations increasingly lost the momentum for structural reform. Many of the Koizumi administration's reforms were indefinitely delayed

〈Figure 5〉 Inflation Rates (Consumer Price Index) in Japan



Source: OECD.Stat

or successfully rolled back under the weight of vested interests.

5. Fourth Wave: Global Financial Crisis

In the wake of the global financial crisis that erupted in 2008, the Japanese economy quickly fell into a recession. The economy was affected more severely than most other advanced economies largely because of its relatively heavy reliance on exports. As private domestic demand continued to be weak from the beginning of the 1990s, exports increasingly became an important source of growth. For example, net exports accounted for about one-third of Japan's growth even when private domestic demand was relatively strong during 2003-2007. The dependence on trade made the Japanese economy very vulnerable to external shocks. Subsequently, at the height of global financial crisis, the Japanese economy contracted for two years in a row with its growth rates in 2008 and 2009 considerably lower than the OECD average as well as the contemporaneous growth rates of the United States.

Against this weak economic backdrop, the Democratic Party of Japan (DPJ) defeated the LDP in the general election of August 2009. In the election, the DPJ ran a successful campaign by tapping into the widespread sentiment that the reform measures under the rule of Koizumi created growing inequality in income, employment, health care and education. Subsequently, mitigating inequality in these areas took priority over promoting strong economic growth in the DPJ government. The DPJ platform includes policies to support SMEs, fixed term workers, families with children, farmers, and free high school education. The government claimed that all these policies could be sufficiently funded

without raising taxes – mainly by scaling down public works, reforming public corporations, reducing the government wage bill, and selling government assets.

However, it became clear from early on in the DPJ government that fully implementing the party's extensive welfare programs was a tall order given the country's worsening fiscal position. Accordingly, the second DPJ administration led by Naoto Kan proposed an alternative approach that paid more attention to economic growth with the goal of promoting social welfare while maintaining sound fiscal position. Under the new approach, fiscal spending was increasingly directed at the areas with greater job creation potential such as health care and social work. Nonetheless, the DPJ lost an election for the upper house of the National Diet in July 2010, largely due to voter disillusionment with the party's welfare platform. In fact, very few of their welfare policies managed to survive in their original forms.

6. Fifth Wave: Tohoku Earthquake

With the help of a coordinated global fiscal stimulus, Japan achieved robust growth in 2010. However, the earthquake off the Pacific coast of Tohoku in March 2011 inflicted a heavy blow on the Japanese economy that was crawling out of economic shocks from global financial crisis. Even compared with the Kobe great earthquake, the Tohoku earthquake was viewed to have more dire implications for the economy not least because of the country's much weaker fiscal position in 2011. The country's public debt accounted for more than 200 percent of GDP in 2010 in comparison with around 80 percent in 1994. This suggests there

was much more limited room for fiscal maneuver following the Tohoku earthquake even though the additional fiscal spending that was required was estimated to be more than double the amount after the Kobe earthquake.

Furthermore, the Tohoku earthquake substantially undermined Japan's productive capacity by destroying power plants, railways, roads and ports. The destruction of major infrastructure disrupted the country's supply networks and hence put a damper on net exports by hurting export industries. Subsequently, the robust growth of 2010 turned into negative growth in 2011 while deflation was still plaguing the economy. This development, coupled with a further increase in the ratio of public debt to GDP, prompted growing concerns over the sustainability of Japan's public debt. Fitch Ratings downgraded the sovereign rating of Japan in May 2012.

III. Great Recession: Possible Causes

1. Macroeconomic and Financial Policy Mistakes

There were a series of macroeconomic policy mistakes in Japan after the Plaza Accord. The Bank of Japan responded to an economic downturn in the wake of the Plaza Accord by aggressively slashing interest rates. However, this expansionary monetary policy fueled the credit boom that in turn created the substantial asset bubbles in the economy. In dealing with the buildup of the asset bubbles, the Japanese government made the mistake of waiting too long until the bubbles

grew too large. In particular, the Bank of Japan was reluctant to raise the policy rate under stable prices. When the Japanese government finally decided to tackle the country's asset bubble problem, the bubbles had already become way too big. The failure to take prompt actions inevitably amplified the magnitude and speed of an economic downturn when the asset bubbles finally collapsed following interest rates hikes.

Adam Posen (1998; 2004) argues that a recession subsequent to the bursting of the bubble developed into the long-running Great Recession mainly as a result of a series of fiscal, financial, and monetary policy mistakes. He points out that there was a slow but solid recovery from 1994 driven by private consumption and investment. However, he argues, this economic recovery was cut off prematurely by contractionary fiscal policy along with banking problems. For example, the consumption tax rate was raised from 3 percent to 5 percent in April 1997. Posen also provides the picture of a strong recovery being aborted by policy mistakes in his description of the country's recession in 2001-2002. In this picture, the economy slipped back into a recession as fears of monetary contraction, coupled with mounting NPLs in the banking sector, led to the collapse of private investment. According to the argument of Posen and others, therefore, Japan's Great Recession was the result of macroeconomic and financial policy mistakes that stymied natural tendencies to recovery.

2. Slow Total Factor Productivity Growth

Total factor productivity (TFP) compares the growth of GDP with the growth of combined capital and labor inputs. Accordingly, TFP growth

represents an improvement in the level of economy-wide efficiency with which capital and labor inputs are used in production. The standard economic growth theory clearly identifies total factor productivity as the engine of long-term growth. According to the standard neoclassical growth models, economic growth unaccompanied by an improvement in total factor productivity is destined to eventually wind down due to diminishing returns to capital. Therefore, total factor productivity growth represents the part of economic growth that would, instead of resulting in mere blips, be sustainable and hence of long-term significance.

The existing studies find that Japan's robust TFP growth in the 1980s fell sharply in the 1990s (e.g., Hayashi and Prescott, 2002; Fukao and Miyagawa 2004). In fact, Japan's TFP growth rate in the 1990s was not only historically low but also lagged considerably behind the contemporaneous growth rates of other OECD countries (Lee 2011). From the perspective of growth theory, these findings suggest that any developments in the demand side during the 1990s may have been relevant for temporary ups and downs around Japan's long-term growth trend, but it was the fall in TFP that was a major force behind the decade-long trend of sluggish growth.

Japan's virtually stagnant TFP growth in the 1990s was on a strong rebound during 2002-2007. According to the Research Institute of Economy, Trade and Industry (RIETI), the growth rate of Japan's TFP rose from the annual average of -0.1 percent over 1991-1999 to the annual average of 0.8 percent over 2002-2007. Lee (2011) also finds that Japan achieved TFP growth at the rate of 1.4 percent per annum on average over 2001-2006 by continuing to close its efficiency gap with the OECD best practices. This TFP performance was in sharp contrast

with the country's slightly negative average TFP growth during the 1990s. Japan's rate of TFP growth during 2001-2006 was also found to significantly surpass the contemporaneous TFP growth rate of the entire OECD area. Therefore, the examination of total factor productivity changes clearly indicates that a relatively durable recovery under the Koizumi administration was accompanied by robust TFP growth. However, the country's total factor productivity began to sharply deteriorate from 2008 in the midst of global financial crisis.[3)]

3. Demographic Change

McDonald (2003) argues that demographic change in Japan served as an important cause of the country's long-running economic stagnation by weakening aggregate demand. In Japan, the total fertility rate that stood at 2.14 in 1973 continued to decline to 1.57 in 1989, and further down to 1.26 in 2005. Japan also has the most rapidly aging population among industrial countries. The percentage of people 65 and older in Japan is among the highest in the world, and moreover, it has grown faster than any other major OECD countries. Japan first entered an aging society in 1970, which is defined as a country with the population share of 65 and older above 7 percent. Then it took Japan 25 years to transform itself from an aging society to an aged society that is a country with people 65 and older exceeding 14 percent of the total population. The same transition took 72 years in the United States. Furthermore,

3) According to RIETI , the estimated rate of TFP growth is -0.8 percent in 2008 and -3.7 percent in 2009.

Japan became a country with its population 65 and older exceeding 20 percent of the total population – a super-aged society – in 2006.[4)]

The demographic change in Japan obviously places increasing strains on its economy. The ratio of those who are economically productive (15 to 64 years old) to those who are dependent (65 and older) suggests that three productive people currently have to share the burden of supporting more than one elderly dependent in Japan. The country's demographic change is also likely to contribute to falling household saving in Japan. According to the life-cycle hypothesis, there is positive saving when people are in their middle age, but negative saving when people pass retirement. Therefore, population aging is likely to be associated with a lower rate of household saving. Japan's household saving rates that were hovering around 11 percent by the mid-1990s began to decline rapidly from 1998 and have remained below 4 percent since 2002. This fall in household saving depressed domestic investment and/or deteriorated current account balance, thereby putting downward pressure on aggregate demand.

In the supply side, demographic change caused a slowdown in Japan's labor force growth in the 1990s (McDonald 2003). Hayashi and Prescott (2002) also note that the workweek length was gradually lowered through the 1988 revision of the Labor Standards Law from 44 hours to 40 hours between 1988 and 1993. A fall in total labor hours worked is expected to decrease marginal product of capital by raising the ratio of capital to output, leading to lower levels of domestic investment and production. Hayashi and Prescott (2002) identify a decline in total labor

4) For a summary of population aging in Japan and other Asian countries, see Lee (2011).

hours worked, along with a slower pace of total factor productivity growth, as a cause of Japan's protracted economic slump in the 1990s.

4. Overcapacity and Nonperforming Loans

The buildup of the asset bubbles under low interest rates created considerable overcapacity particularly in the construction sector. However, these overcapacity problems never had a chance to be effectively addressed as the government continued with pump-priming spending with the goal of creating public works jobs. Government orders accounted for about 30 percent of total construction orders between 1991 and 2001. The unresolved overcapacity evidently held back a durable economic recovery by constraining new capital investment and hence significantly undermining the economy's productive efficiency. It is often argued that overcapacity was behind a relatively slow pace of IT-related investment in Japan.

Mounting NPLs in Japan's banking sector also served as a big clog that prevented a sustainable recovery. Regulatory forbearance allowed the Japanese banks to delay in recognizing losses on bad loans, thereby creating insolvent "zombie" companies especially in the real estate, construction, and wholesale and retail sectors. Such "zombie" firms hampered new capital investment by significantly reducing the pool of loanable funds available for sound borrowers.[5] Nonetheless, there was little remedial action taken by the government until it finally adopted a more aggressive approach to dealing with nonperforming loans

5) See Caballero et al. (2008) for empirical evidence.

problems in 2002-2003. In October 2002, the Koizumi administration introduced a new policy initiative called the program for financial revival. The launching of this program was an important event in expediting the resolution of NPLs because the program laid out specific numerical targets and, more importantly, deadlines for meeting them.

5. Ineffective Fiscal Stimulus

It is often argued that fiscal stimulus was a more effective means of providing liquidity into the Japanese economy than monetary expansion in the past couple of decades because the economy was caught in the so-called liquidity trap most of the time.[6] The Japanese government indeed continued to pursue expansionary fiscal policy that nonetheless failed in large part to produce a sustainable recovery while creating substantial public debt in the country. There were nine fiscal stimulus packages totaling more than 123 trillion yen between 1992 and 2000, followed by extra fiscal spending of almost 77 trillion yen at the time of global financial crisis of 2008 and that of more than 16 trillion yen in the wake of the Tohoku earthquake. However, fiscal stimulus generated, at best, only temporary recoveries that tended to be quickly reversed after each round of fiscal spending became complete.

Some argue that the effectiveness of fiscal stimulus in Japan was hampered by its relatively low fiscal multiplier. Estimates of the country's fiscal spending multiplier often fell below 1.[7] Furthermore, they were

6) See Krugman (2009) among others.
7) See Kalra (2003), Bayoumi (2000) and Yoshino et al. (2000) among others.

generally found to decline over time.[8] The country's relatively low fiscal multiplier was partly due to the composition of its fiscal spending that was skewed toward lower multiplier spending. For example, the share of central government spending on social security, which is generally viewed to have a lower multiplier than capital spending, increased to almost 30 percent of total government spending in 2010 from less than 20 percent in the 1980s and 1990s. In addition, Kuttner and Posen (2001) argue that the country's weak banking sector may have undermined the private sector response to fiscal stimulus by failing to play an effective intermediary role because of its NPL problem.

Faced with stagnant tax revenues, the government increasingly turned to new issuance of government bonds to fund their fiscal spending. In 2010, the Japanese government financed almost 50 percent of their spending by issuing new government bonds. Consequently, the level of public debt sharply increased over time, exceeding 200 percent of the country's GDP in 2010. The burden of servicing public debt also increased in steps with a rise in the debt level. In 2010, the Japanese government used about 12 percent of their total spending to retire part of their debt and about 11 percent to make interest payments on the existing debt. The high level of debt servicing costs obviously had some dampening effects on the country's fiscal multiplier. Finally, it is possible that a rapid rise in public debt prompted concerns about future tax increases, muting the effect of fiscal spending as suggested by Ricardian equivalence.[9]

8) For example, the public investment multiplier estimated by the Cabinet Office declined from 1.3 in 1991 to 1.1 in 2004.

9) Ricardian equivalence predicts that debt-financed fiscal spending may have no impact

6. Weak Private Domestic Demand

Private domestic demand that accounted for around 85 percent of GDP in 1990 continued to decline to less than 80 percent in 2010. Private investment exhibited a particularly big drop from more than 30 percent in 1990 to around 20 percent in 2010. Possible factors behind stagnant investment spending include falling corporate profits under deflation, the relocation of production base abroad under the strong yen, and the buildup of nonperforming loans and delays in restructuring. In particular, non-tradable sectors with low productivity tended to show a decline in corporate investment even in an economic upturn.

Although the share of private consumption in GDP slightly increased from around 53 percent in 1990 to 59 percent in 2010, a number of factors were weighing down household consumption to prevent its more robust growth. For example, low fertility rates and rising life expectancy in Japan rapidly changed the age structure of its population. In particular, people aged 60 and over with a low marginal propensity to consume held about one-half of personal financial assets, making a big turnaround in private consumption increasingly less likely even in an economic upturn. Private consumption also suffered while rising unemployment and low interest rates depressed household disposable income. In addition, Japan's labor income share consistently decreased as exporters tried to save labor costs to cope with the strong yen.

on consumer spending because consumers expect higher spending will lead to future tax increases to pay back the debt. For a summary, see Barro (1989) and Seater (1993).

7. Political System

Inert political leadership in Japan served as a major obstacle to implementing necessary measures to end the country's persistent economic stagnation. The political inertia was the result of several factors including the country's own political system. One important feature of Japanese politics is that major political parties are composed of factions. In this system, a prime minister with low approval ratings is subject to the risk of being forced out of office by his own party due to factional dynamics. As a result, anyone in office would follow his approval ratings very closely and naturally have an incentive to avoid politically risky policies that are detrimental to his approval ratings. The policy measures that Japan needed to get out of the long-running economic slump and get on the sustainable growth path, such as structural reforms, obviously entailed substantial political risks. Subsequently, most administrations decided to put these measures aside as much as possible rather than tackling them headlong.

Another salient feature of the Japanese system is the prominent role to be played by government bureaucrats. In Japan, government bureaucrats traditionally held sway over the country's economy through industrial policies and complex government regulations. The keiretsu system also gave the government a means to exercise indirect controls over the corporate sector. Each keiretsu was typically organized around its main bank(s) that were generally put on a tight leash by government officials. Although the Japanese system showed some merits in the years of high growth, the rigid bureaucratic system failed to take timely actions

to dispose nonperforming loans and introduce legal frameworks needed for corporate restructuring. Takenaka (2008) observes that the typical bureaucratic sense of "infallibility" – that is, government bureaucrats never admit that their past policies were inadequate – was largely behind widespread bureaucratic inaction.

Government bureaucrats are an integral part of the so-called "iron triangle" of politicians, bureaucrats and businesses. Businesses sponsor politicians and provide lucrative post-retirement jobs to bureaucrats in return for policy and regulatory favors. Feldhoff (2002) describes the workings of this triangle in the area of construction. The system of collusion between politicians, bureaucrats and businesses led to massive government spending on public works projects and thus contributed to growing public debt. The triangle also undermined economy-wide efficiency by creating wasteful public investments and protecting incompetent businesses.

IV. Concluding Remarks: Additional Challenges

Following exceptional monetary easing and massive fiscal spending, the Japanese economy began to show encouraging signs lately. Economic growth is picking up and prices are rising. However, if the country's recent history is any guide, this recovery is still in the initial stage and does not guarantee the exit from the Great Recession. This study shows that Japan's two-decade long economic stagnation can be divided into five distinct waves in each of which the country's economic recovery easily collapsed under the weight of external adverse shocks.

Consequently, there is a good chance that the current recovery would end up as another episode of disappointment and simply mark the beginning of the new sixth wave of the country's Great Recession unless underlying risks that could abort the recovery are properly addressed.

This paper aims to identify some of those underlying risks by examining the possible causes of the Great Recession in the past five waves. The causes observed in the past five waves represent challenges still relevant to today's formulation of policies for a sustainable recovery that is resilient to external shocks. In the current round of economic recovery, however, there are additional challenges resulting from radical macroeconomic policies that have been pursued since the start of the Abe administration. For example, the unconventional easing program adopted by the Bank of Japan may have helped to finally bring in the general trend towards inflation, but it also carries increasing risks associated with the program's eventual exit. Unwinding exceptional monetary measures undoubtedly affects financial markets to a great extent, but the precise impacts of the unwinding especially with the Japanese magnitude are extremely difficult, if not impossible, to fathom in advance. Therefore, Japanese policymakers face the difficult task of navigating through enormous uncertainty to design an appropriate exit strategy that avoids triggering financial instability.

In addition, the aggressive fiscal expansion under the watch of the Abe administration has added to pressure on public debt that has already swelled to the level more than twice the country's total GDP. Despite its considerably high level, Japan's public debt was not traditionally viewed to pose a serious risk of a sovereign debt crisis

mainly because the country managed to accumulate its public debt without resorting to international borrowing thanks to its persistent current account surpluses, substantial foreign asset holdings, and high rates of private saving. Of the total government debt outstanding, more than 90 percent is held domestically, and in particular, more than 40 percent is held by Japanese banks. In fact, government bond holdings account for roughly a quarter of total assets held by Japanese banks. Despite relatively low nominal yields, domestic investors have been willing to hold Japanese government bonds because deflation put real returns higher than nominal returns.

However, there are signals suggesting that things could change. First, there is a growing possibility that a current account deficit, which was never a serious concern for the Japanese economy, may become more frequent and persistent in the future. The country's net trade in goods has continued to register a deficit since the second quarter of 2011. This deficit was initially driven by temporary developments following the Tohoku earthquake. The shutdown of nuclear plants increased the import of fossil fuel for thermal power plants, and the disruption of supply networks slowed the country's exports. However, there have been more enduring developments outside of the country, including an economic slowdown in Europe, a slower pace of growth in China, and a slowdown in U.S. consumption. Domestic developments such as the relocation of production base abroad and aging population are also viewed to have more lasting negative impacts on the country's current account balance.

In addition, a fall in household saving may have widened the saving investment gap, exerting downward pressure on the country's current

account balance. The household saving rate declined from 10 percent to 2.1 percent between 1990 and 2010. The combination of swelling budget deficits, falling private savings and expanding current account deficits indicates that government borrowings are increasingly financed by foreign sources of funding. The increase in foreign investor holdings makes the government bond market more vulnerable to the risk of capital outflows and the subsequent increases in interest rates. This means an end to the relatively smooth operation of public debt management in which the majority of government bonds are currently absorbed by domestic banks. Furthermore, if the government successfully wins the battle to fight deflation, nominal yields on government bonds are likely to increase once inflationary expectations are in place. If tax revenues continue to stagnate, the rapid increase in debt-service burden is likely to cast doubt over the sustainability of Japan's substantial public debt. This possibility suggests that Japan is not entirely immune from the type of a sovereign debt crisis that follows a vicious circle of growing public debt as witnessed in Europe.

Finally, it should be noted that Japan's Great Recession also provides valuable lessons for the current Korean economy. Many observers find interesting parallels between Japan in the 1990s and today's Korea. First, Korea that became an aging society in 2000 is expected to enter an aged society in 2018 while Japan passed the threshold for an aged society in 1994. In fact, the speed of aging is even faster in Korea than in Japan, given that the transition from an aging society to an aged society took 25 years in Japan. In working hours, 40 hour workweek was gradually extended by law to Korea's all workplaces between 2004 and 2011, whereas the same workweek was gradually adopted in Japan by

1993. According to Hayashi and Prescott (2002), a fall in total labor hours worked, along with a slower pace of total factor productivity growth, served as a main cause of Japan's persistent economic slump in the 1990s. Furthermore, the recent rapid depreciation of house prices in Korea has prompted concerns that the country may face a long-term decline in real estate prices that has plagued Japan since the 1990s. Therefore, many of policy challenges identified in this study also have important bearings on the efforts to prevent the recent economic slowdown in Korea from developing into persistent stagnation in the manner of Japan's Great Recession.[10)]

10) Yoon and Kang (2012) also discuss some parallels between the Korean and Japanese economies.

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ABSTRACT

일본경제의 장기침체: 개관 및 정책과제

이정연

일본의 지난 "잃어버린 20년"을 묶어 일반적으로 장기침체 기간으로 정의하고 있으나 일반적인 믿음과는 달리 일본이 이 기간 동안 지속적으로 경기침체를 경험한 것은 아니다. 따라서 본 연구는 일본의 장기침체 과정과 원인을 연대순으로 살펴 보는데 있어 전체 기간을 다섯 개의 소기간으로 나누어 보다 명확한 이해를 도모하고자 한다. 한편 이를 통하여 일본이 장기침체를 탈출하여 지속 가능한 성장경로로 이동하기 위한 정책과제를 도출하고자 한다. 마지막으로 본 연구는 현 아베 정부에서 시행되고 있는 거시경제 정책들이 장기침체 탈출 노력에 어떠한 정책 시사점을 갖고 있는지 살펴 본다.

주제어: 일본, 장기침체, 경제성장, 정책과제