Japan-Did economic success breed chronic stagnation?

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This paper contends that there is a continuum in Japan's experience of growth and decline from the 1990s to the turn of the century and beyond. A lingering attachment to the bureaucratic, financial and political underpinnings of high-growth success affected Japan's response to critical shifts in national and international economic circumstance once economic catch-up had been achieved. In the tensions that emerged between shifting circumstance and established practice can be traced the origins and nature of the 'boom and bust' years, the lack-lustre reform programme that ensued and the reasons for continued stagnation.

By the end of the 1980s western observers were becoming increasingly sceptical of those distinctive features of Japanese capitalism that had hitherto been the scourge of neoclassical economic liberalism. During its high-growth years Japan had embraced a system of corporate governance that favoured employees more than shareholders and which saw firms more as communities than as private market 'owners'. Core employees of large and medium-sized firms enjoyed 'lifetime employment', seniority linked wages, the imposition of firm-specific skills, and the predominance of 'enterprise unions' which embedde ruling corporate values. Banks rather than the capital market were the principal source of investment funds to the private sector, especially for riskier long-term ventures. The stability and adaptability of firms were enhanced further by the flow of information and other sources of support from powerful business groups linked by cross-shareholding arrangements. Businesses competed in final markets but within a system where the rules and the limits of such competition were directly influenced by the 'visible hand' of a state bureaucracy determined to foster national strength and security through international competitive advantage.

The collapse of the 'bubble economy' in the early 1990s and the ravages of the post 1997 financial crisis throughout Asia led scholars, business-leaders and policymakers to criticize openly the institutions and practices that had featured so prominently in Japans' recent past.

It appeared clear in retrospect that Japan's emerging troubles were not just those of policy error and economic mismanagement. The 'lost decade' of the 1990s revealed pervasive problems of institutional fatigue, social malaise and a loss of national purpose against a backdrop of radical changes in the external economic environment.

By the end of the 1980s the institutions of the 'development state' which had earlier fostered a public/private sector alliance to orchestrate an export-led programme of national rejuvenation faced a new phase of global pressure involving interlocking national economies, revolutions in technology and communications and a marked transformation in the dynamism of Japan's regional neighbours for which Japan's prevailing political economy had not been designed. The country's domestic infrastructure and the political system had been tied to a very different bipolar international order.

The high growth developmental system had incorporated reactive adjustment, piecemeal adaptation and pragmatic change. Its essential components of export orientation, control of capital, corporate alliances and a distinctive employment system were all liable to unpredictable change. The system had become costly in terms of the inherent trade offs involved and the resources required to sustain subsidies, tax cuts, and technological upgrading.

The dramatic shift in the international environment during the early 1980s finally 'de-legitimized the working of the growth system, and…helped accelerate the process of its aging'. Strains emerged from a variety of directions. Global capital flows and financial deregulation put pressure on Japan to adopt the trading and financial best practice standards of the competitive West; rising personal incomes and demands for improved social welfare weakened the traditional stoic acceptance of 'rich Japan/poor Japanese'; there were acknowledged difficulties in producing skilled labour for national upgrading whilst promotion of inward and outward investment pushed production networks beyond the national boundary weakening the national economic core.

At a more fundamental level Japan's emerging problems resulted from the very pursuit of the export-oriented scrap-and –build policies that had underpinned earlier success. Faced with shifts in global demand and pressure to open up the Japanese domestic economy to outside finance and corporations, Japan was forced from the 1980s both to hollow out its own economy to gain competitive trading operations in cheaper counties abroad and to face the exposure of unproductive and heavily subsidized sectors which were proving costly to support but which were politically costly to abandon.

In the high growth period Japan had exercised control over the free flow of capital to industry via an institutionalized expansionary monetary policy without having to concern itself of the exchange rate. The state was able to focus on export led growth and protect its domestic markets because of the support of the USA - for cold war anti communist reasons and because the US realised that multilateral trade would be helped by allied countries building up their economic capacity.

Contingent conditions that had earlier enabled the Japanese economy to tolerate excessive competition based on over lending, over borrowing and a determination to expand market share began to weaken. The collapse of the fixed exchange rate system and the free flow of capital across national borders shifted the emphasis away from the expansion of trade and production towards expansion of finance and monetary activity under a more liberalised order. From the 1980s large corporations were able to source funding from outside the Japanese banking system, forcing the domestic banks to seek out softer and riskier customers to lend to in order to protect profit margins. The 'bubble economy' was in the making.

What was equally if not more troubling for the future was that the monitoring of the banking system which had traditionally been regarded as central to economic growth and stability was found to have been less robust that formerly believed and became even less transparent and effective from the mid-1980s onwards. Moreover, 'lifetime' employment continued to shelter surplus labour; the government continued to protect sunset industries; cartels continued to shelter inefficient sectors including shipbuilding, aluminium, textiles; and agriculture continued to garner financial resources because of its significance to the political establishment. The high growth system had produced a dysfunctional hybrid of super-strong exporting industries such as cars and machinery and super-weak domestic sectors such as food processing and textiles. Japan had moved from picking winners to protecting losers; switching from market-conforming 'accelerationism' to market-defying 'preservatism'.

According to Katz 'Japan's malaise was woven into the very fabric of its political economy.' The country had 'a very thin social safety net, and so in order to protect jobs, weak domestic firms and industries were sheltered from competition by a host of regulations and collusion among companies. Ultimately, the system limited productivity and potential growth.' Japan faced a 'built-in economic anorexia'. Personal consumption lagged not because people refused to spend but because the structural flaws of a two tier Japan of skewed productivity growth caused real household income to fall as a share of real GDP. The government had to pump prime to sustain demand.

The problem that was emerging but which was insufficiently addressed was that the hitherto substantial rise in gross capital formation (an increase in real terms from 13.1% of GDP in 1955 to 32.8% in 1973) was not destined to continue. Corporations faced rising wage costs at a time when Japan was reaching the technological frontier. It had to rely more on innovation than imitation making profitable investment both costlier and scarcer. Demographics affected the outcome. In the two decades prior to the 1990s the number of Japanese people in the 45-60 age group expanded by over 42%. This was a group conscious of the need to save. The inadequate welfare state and the paltry levels of real interest rates meant they had to do so, moreover, over prolonged periods to effect their retirement plans. But this high savings rate sustained the supply of funds for corporate investment. Had capital expenditure been curtailed and a more deliberate shift made towards raising the household sector's share of national income consumption may have been able to replace capital spending as a source of aggregate demand. This neglect of sustained domestic demand, as we shall argue below, proved fatal to Japan's longer-term economic prospects.

Japan's 'dual economy' had been sustainable in the past only insofar as efficient exporters had earned sufficient profits to prop up the less efficient domestic sectors. But by the late 1980s high costs at home and a rising yen were squeezing exporters encouraging them to invest in offshore markets rather than in Japan itself, dragging down the productivity of the entire economy. The proportion of Japan's total manufacturing output produced offshore rose almost fivefold between 1985 and 1999. Large domestic Japanese enterprises such as Toyota, Hitachi and Toshiba and subcontractors of the larger Japanese firms made strategic alliances with corporations overseas eroding their link with small and medium size businesses threatening revenue, profits and jobs. Japan's transnationals began to serve the country's domestic market from their offshore bases that partially nullified Keynesian type domestic fiscal stimuli given that consumption could be met from global outsourcing. These developments, however, merely illustrated the potential problems that Japan had fostered by pursuing economic policies that tied the wider public interest to the ambitions of the corporate sector. Over time, the Ministry of International Trade and Industry's celebrated ability to influence the direction of industry in the public interest diminished, with economic power effectively being yielded to Japan's giant corporations. These corporations shaped the country's industrial structure and economic development to suit their own strategic interests 'with production being organized along hierarchical lines and control…being exercised by an elite corporate group of decision makers' and not necessarily in the wider public interest.

Constraints on long-term growth

In its stylized form, Japan's high growth 'developmental state' promoted a plan-rational authoritarian but paternalistic government incorporating institutionalised state/business relations in an embedded autonomy under which the bureaucracy, autonomous from societal forces, could devise long-term policies without undue influence from private interests. Its operational potence, however, lay in its alleged capacity to anticipate change and to reorient policies accordingly. That proved ultimately to be Japan's Achilles heel.

Even if we accept the power and influence of Japan's developmentalist strategy during the high growth years, involving the key economic agencies of the Ministry of International Trade and Industry, the Ministry of Finance and the Bank of Japan. MITI's prejudice for promoting giant corporations at the expense of smaller firms; its approval of cartelization which increased industrial concentration; its reduction of domestic competition; and its continued acceptance of government/business networking which worked above all to meet the strategic interests of the corporate sector sowed the seeds of later decline.

Herein lay a cruel irony. The long-term relationships of firms with labour, creditors and suppliers that had earlier enabled the corporate sector to weather cyclical fluctuations and to pursue long-term investment ultimately proved to be an almost hermetically sealed source of inflexibility. The shift in power from bureaucrats to politicians in the wake of the post bubble years downplayed growth strategies in favour of pork-barrel politics. Banks that had become risk averse in the immediate aftermath of the collapse in equity prices from 1990 began thereafter to prop up indebted and beleaguered sectors rather than deal with their plight in accordance with internationally accepted financial criteria.

The economic, financial, political and social manifestations of Japan's cyclical recessions and ultimate secular decline from the 1990s onwards continue to be the subject matter of research monographs. For the purposes of this paper we identify some of the over-arching characteristics of Japan's economic malaise during that period in order to identify and help explain the long shadow cast by its earlier success.

The institutional mechanisms that suited catch up were not in themselves capable of sustaining long-term growth or undisputed economic leadership. One perceived weakness was that by relying upon the state as coordinator to assist in the diffusion of new technologies at relatively low transaction cost, fast growing economies such as Japan had developed advanced non transaction sectors but relatively undeveloped transaction service sectors. This weakened the country's ability to translate consumer wants into effective market demand and domestic production thereby compromising the likelihood that fiscal or monetary stimuli might generate a home grown recovery.

The institutional perspective

The complex interlocking array of institutions and the array of social and political accommodations that had epitomised the development state in the high growth period had created an inherent and powerful 'institutional logic' that stalled Japan's adjustment. Specific historical accommodations produced social systems of production designed to realize particular political and economic goals. They in turn reflected constellations of power and interests that became ossified in an institutionalized reality resistant to change. Government bureaucracies may have acted autonomously from society interests in the early stages of intervention but over time such autonomy was diminished as social groups were provided increased access to the state apparatus. As a consequence economic policy became influenced less by the competition and compromises fashioned between the integrated state and the business sector as much between different state agencies and their sectoral alliances. Important industrial sectors such as computers and autos were progressing without or even in spite of bureaucratic assistance while the more strident vested interests of traditional industries and their regulators were straining government-industry relations. A formerly responsive national bureaucracy was being replaced by patterned pluralism, 'multiple pockets of highly specific power, many of them operating at cross purposes with one another'.

At the same time the hitherto invincible electoral base of the Liberal Democratic Party came under threat as a result of the very economic successes it had helped to create. Urban growth has spawned a more distinctive middle class conscious that the producer interests so close to the bureaucrats' hearts had gained more from prosperity than had most Japanese citizens. With the rural population in decline and with politicians and non-bureaucratic groupings including the courts and local governments calling for greater clarity and detail over policy formulation traditional lines of bureaucratic authority were frequently challenged. Unfortunately one way of shoring up influence was to preserve traditional areas of support. The upshot as Pempel puts it 'was to drive a wedge into the business community and into ministries with close ties to different industries. One pull was that towards deregulation, liberalization, and rapid adjustment to international economics; the other was toward greater bureaucratic regulation, protection and the promise of efforts at structural readjustment'.

Deregulation from an Anglo-Saxon or Anglo-American perspective emphasised a market-enhancing regulatory framework. Japanese bureaucrats who were themselves given responsibility to encourage initiatives were more inclined towards 'strategic reinforcement'. The continuing institutional legacies of the development state ensured a wide gap between rhetoric and reality in the reform process. Too many people had a stake in the established order. With a coalition of powerful political interest groups intent on retaining wealth and power and in the absence of a crisis sufficient to pose a major threat to growth and stability many of Japan's ruling elites were able to muddle through the 1990s accepting incremental but not fundamental reform. It was never a question therefore of simply overcoming vested interest groups. The dilemma was a call to replace a belief in corporate social responsibility and the array of trust-based relationships among business, labour and the government with a firmer commitment to the free play of market forces and rampant individualism. This proved to be a formidable and continuing challenge.

The legacy of the 1990s

It has to be conceded that the continuing demands made on Japan during the 1980s and beyond to deregulate and mirror western style competitive free markets did not go unheeded. The pace of reform however proved to be piecemeal and painfully slow. Part of the reason for this lies in the continuing resonance of the post-war developmental psyche. Japan was aware of the need to address critical issues of structural reform, an ageing population, financial fragility, and a bifurcated labour market that worked against the interests of young and female workers, and to do so in the face of powerful political and economic vested interests. But its responses on the whole were formulated in a familiar developmental hue which gave prominence to the 'producer interest' rather than the utilitarian greater good, to an emphasis upon manufacturing competitiveness as a priority of policy, and to a call for the population to adopt lifestyles that would support even at some cost to themselves a national project of revitalization in a generic Japanese rather than Western fashion.

A close examination of Japan's political economy during the 1990s helps to explain these biases in policy.

The interest rate tightening introduced after the collapse of the equity market at the end of 1989 had a more draconian effect on the Japanese economy than merely curbing real-estate lending. The swift about turn in monetary policy led to a dramatic deflation the impact of which soon deepened. The drastic decline in stock and real estate prices weakened the health of banks and other financial institutions as the value of real estate collateral eroded and as the decline in the value of banks' equity holdings put pressure on bank capital. It was clear by 1992 that asset price deflation had led to deep falls in the value of bank capitalization and loan collateral and that the banking sector was riddled with huge stocks of nonperforming loans. It was critical in the immediate term to stem even further depreciation of capital values if a deflationary downward spiral was to be avoided. Discount rates were lowered from 5.5 % in July 1991 to 3.25% in July 1992, their lowest level since May 1989. Further reductions took rates to 2.5% in February 1993 and to 1.75% in September 1993. The growth rate fell to below 1.2% for three years 1992-4; the inflation rate of just over 2% at the start of 1992 had fallen to 0% by the middle of 1995.

Despite repeated reductions of nominal short-term interest rates between 1992 and 1995 the economy languished, suggesting that the authorities had seriously underestimated the impact of deflationary forces. What distinguished Japan was not the depth of recession per se (it did not reach the levels experienced by industrialized nations in the 1930s) so much as the duration of the downturn and the persistence of deflation and financial distress even at a time when interest rates had been driven close to zero levels, a situation not witnessed elsewhere.

Much of the blame for the deepening recession of the first half of the 1990s was directed at the Bank of Japan. The generally accepted view is that although the Bank systematically lowered interest rates in the aftermath of the bubble, it nonetheless kept the growth rate of base money extremely low, despite the mounting evidence of a decline in economic activity. Having allowed the money base to grow too much in the late 1980s –its annual growth rate had doubled from 6 to 12 per cent during 1987-9, driving the speculative mania and the creation of bad debts – the Bank let it fall to an annual growth rate of only 2 per cent during 1991-3.

In the nervous climate of the times, Japanese banks became increasingly risk averse, rationing credit and refusing to lend to borrowers thought likely to default. To make matters worse, banks were under pressure to meet new capital adequacy requirements that came into full effect in 1993. The Bank of International Settlement set equity (tier 1) capital at 4% and the sum of tier 1 and tier 2 capital – the latter primarily subordinated debt – at 8% of a bank's risk-weighted assets. The effect was to circumscribe lending further, pushing marginal borrowers into bankruptcy, raising the levels of non-performing loans, and deepening the determination of the banks to restrict credit, especially to small and medium-size firms. The continuous pressure exerted on banks' balance sheets by nonperforming loans meant that bank lending continued to decline despite a loosening of monetary policy, putting downward pressure on private investment.

A combination of financial, institutional, and political pressures both contemporary and idiomorphic ensured that low interest rates, structural misalignments, and a deepening problem of bad loans within the financial sector were able to co-exist in a manner that frustrated the emergence of a more accommodating monetary stance.

Part of the problem was that the authorities were obliged to meet pressing and often rapidly changing economic and financial conditions without having considered whether their panoply of policy instruments, or more precisely policy priorities, needed to be altered. One problem arose from the deterioration in the formal main bank/commercial bank relationship of the high-growth years of the 1960s and 1970s. At that time the main bank had played an important role in allocating capital to productive investment and in facilitating industrial restructuring. As a large shareholder and often principal lender of a troubled company, the main bank would often initiate bailout processes or restructure debt, acting to rescue (albeit with varying success) some of the country's largest companies and through them the reputation of the banking sector as an integral and trustworthy partner in the developmental agenda. Troubled firms in which a main bank had a large equity share were more likely than not during the pre-bubble period to downsize, incur layoffs, and change their management structure, often enjoying better performance as a result.

However, as lending activity became riskier and less adequately monitored during the bubble years of the 1980s, the banks were less able to play the role of independent arbitrator than they had in the past, being both the source of and solution to the difficulties facing firms. Corporate restructuring became less of a priority and earlier main-bank-led corporate restructuring broke down, largely under the burden of nonperforming loans. Moreover, the main bank system itself came under stress. The main banks were reluctant to allow borrowers to default since that threatened the need to absorb some of the losses incurred by other creditors and because any default would reflect badly on their monitoring operations. In the face of regulatory weakness and the traditionally limited ability of shareholders to control bank activity, banks increasingly exercised forbearance, restructuring nonviable loans, extending loan maturity dates, increasing the ratio of unsecured loans as a percentage of total loans (a reversal of the trend in the late 1980s), and opening new credit lines to allow borrowers to repay overdue loans. Weak corporate governance enabled bank management to focus on market share rather than profitability, while the absence of adequate accountability reduced the incentive for banks to acknowledge the scale of the nonperforming loan problem or to fashion policies to meet it. It was easier to await a revival in stock and property prices or a more general upturn in economic activity.

It was against this background that Japan became embroiled during the first half of the 1990s in a misallocation of credit which in some respects proved as debilitating in its effect on productive investment as had the sudden switch from easy to tight and rationed credit. Large Japanese banks engaged in sham loan restructuring to keep credit flowing to otherwise insolvent borrowers (zombies) at the same time as they discouraged the entry of and investment by healthy firms, a situation exacerbated by the tradition of banks holding shares in some of their principal distressed borrowers, who in turn held bank shares. It is questionable, therefore, whether business investment slowed from 1991 to 1997 primarily because of a credit crunch.

The essential problem faced by the Japanese banking sector was that two complementary forces were at work; the one to reign back over-generous credit allocation that might through imprudence harm the capital bases of banks in general, the other to protect any further damage to the credibility and therefore financial stability of banks by shoring up those very firms whose bad loans had helped cause financial distress in the first place. 'Zombie congestion' exacerbated financial frictions by lowering collateral values, even for healthy firms. All this stifled job creation, suppressed the incentive of inefficient firms to shed workers, and lowered industrial productivity, delaying the likelihood of rapid economic recovery.

Banks continued to extend credit to unworthy or at least financially suspect borrowers partly because of the institutional setting in which they were obliged to operate. The nature of bank regulation and supervision actually provided perverse incentives to provide additional loans to weak firms. Banks willingly rolled over loans to their existing distressed firms to avoid revealing to the public the scale of losses on their balance sheets. By allowing troubled borrowers to survive the banks could avoid having to record the loans as realized losses.

Nor were the pressures ever entirely financial. There can be little doubt that political and administrative reaction to the troubled banking and corporate sectors during the first half of the 1990s served only to worsen the situation. Down to 1993 most regulators and politicians believed that Japan would soon resume its growth trajectory. The adjustment to asset prices was underway and corporations were promising to engage in cost cutting reforms; fully-fledged public action, it seemed, was not really required.

This left the financial sector particularly vulnerable. The adaptive institutional network responses of earlier decades were now found wanting in the face of the informational requirements necessary for effective financial regulation. They failed to produce any timely shift from relations-based regulation to rules-based regulation. The Liberal Democratic Party was heavily reliant upon the MOF for details of the state of the financial sector. But the information supplied by the Ministry proved tardy and incomplete so far as the fragility of financial institutions was concerned. The MOF was content to keep banks afloat, even with bad debts, if it avoided bankruptcies and layoffs until such time as a recovery in economic activity and asset (especially land) prices occurred, and this the more so given that many nonperforming loans were concentrated in the politically sensitive sectors of real estate, construction, retail, and service industries. The balance of interests between the banks, parliamentarians, bureaucrats and businessmen, in other words, favoured inaction.

Full disclosure of the scale of nonperforming assets and the health of individual banks threatened a severe collapse of public and overseas confidence in the sector as a whole. In the absence of adequate procedures to deal with a troubled financial sector save for the time-worn precept of burden sharing, the authorities, juggling at once to impose greater regulation and supervision and to dispose of a huge volume of bad debt without invoking systemic crisis, simply bought time. Their actions stood in stark contrast with the Nordic countries, for example, which embraced transparency and swift remedial policy to curtail the impact of their own banking crisis in the 1990s. In Japan, however, there was hardly any pre-emptive action by government before 1997 to formulate a strategy for insolvent banks or to inject capital into weak banks.

To appreciate fully the balance of action and inaction on the part of the major financial agencies, it is necessary to consider briefly the political context in which financial policy was forged during the first half of the 1990s. The LDP briefly lost control of government in 1993 after almost forty years of political supremacy. In the aftermath of high profile financial scandals following the collapse of the bubble, Japan adopted a mixed voting system, including proportional representation, in place of its single non-transferable voting system. Under the latter scheme between two to six parliamentary representatives had been elected from a single district. Many of them came from the ruling LDP party and therefore competed amongst themselves, waging candidate-centred campaigns rather than policy-centred ones. This mobilization of personal votes was time consuming and costly but it had enabled the LDP to garner sufficient representation to form single-party governments without coalition partners. The revised system from 1993 penalised smaller parties in favour of the large major political groupings to whom aspiring politicians wished to be associated. Although the LDP regained power in 1994 in coalition with the Social Democratic Party, politicians thereafter became increasingly embroiled in electoral and power concerns and intraparty conflict rather than in addressing the pressing economic and financial concerns before them.

Traumatized by its loss of political majority, the LDP sought desperately to preserve its influence and authority especially among the domestic interests it had long safeguarded, namely farmers, the construction industry, big business and small retailers. It swiftly distanced itself from the criticisms then being levelled against the MOF for regulatory incompetence and signalled the need for new forms of financial administration and regulation. As Johnson puts it, the LDP 'no longer much cared about the LDP's chief domestic function: giving the economic bureaucracy enough autonomy for it to cultivate growth industries for the future… [It] increasingly indulged in 'bureaucrat-bashing' in an attempt to shift the blame for the recession.'

For its part, the MOF, threatened with a loss of power, became increasingly balkanized. Greater transparency and measured reform threatened to expose its paltry regulation of bank solvency and to deepen criticism of its operational efficiency. With a well-developed instinct for survival, it ruptured the flow of information, stalled regulatory reform and systematically disguised the full extent of the country's fragile financial condition for fear of being called to account for its failures in financial supervision. In the high growth period, it had been assumed that the Ministry would rescue failing financial institutors in order to protect national rather than strictly financial goals. Now it seemed that the same Ministry was more concerned with disguising past supervisory neglect than it was in insisting on better accounting procedures and the management of financial distress, its latent capacity to formulate effective remedial policies undermined by political pressures and a fervent desire for self-survival.[1] None of the leaders of the LDP after its resumption of power in 1994 spawned fundamental reform. They continued to placate vested interests. The same network of LDP/MOF relations that had 'advanced low –level change in earlier periods worked against bold reforms in the face of crisis'. It would have required a substantial degree of political coordination to have effected change in such an environment. The existing diffusion of responsibilities and the horizontal linkages between institutions made change in one area often dependent upon change in another, requiring political leaders to take bold initiatives in risky directions. That did not happen. Political intervention was haphazard with reforms promoted in a bottom-up manner by MOF officials, which only delayed democratic control of financial administration.

What became apparent down to 1997 was that much of the regulatory forbearance and operating procedures of the 1980s had been carried over largely unhindered into the subsequent decade.

This should not have occasioned much surprise. It had been customary since 1927 for Japan's financial institutions -especially the city banks- to be seen as wards of the MOF. The Ministry was sovereign but did not operate as a regulator with explicit legal powers. Nonetheless, the MOF's regulatory system had served it well during the high-growth period. But by the 1990s the information requirements for effective regulation had become greater and more complex, outstripping the Ministry's traditional informal style of regulation and control. Faced with the crisis of the 1990s, the Ministry strove to keep their wards alive and functioning, refusing in principle to let banks fail. It supported banks in their efforts to bolster margins and profits to disguise the nakedness of their financial indebtedness, and encouraged mergers and private-sector bailouts until the scale of the crisis rendered such traditional self-help redundant. The Ministry insisted as late as 1997 that no public money would be needed to help ailing banks. It is hardly surprising that Japan by 1997 faced a major banking crisis.

The government's attitude to fiscal policy made matters infinitely worse. Growth had resumed in 1996 following tax cuts and the launch of an active fiscal policy. Nonetheless the Ministry of Finance was determined to resurrect fiscal rectitude as a central plank of policy. Despite growth having risen to 3 per cent only a year before, the government committed a major policy error: sharply reversing fiscal policy in 1997. Taxes were raised and spending cut. Authorities took the excessively optimistic view that the private demand-led recovery, which had already been sustained for almost three years, would continue and that it could proceed with cutting the deficit without inflicting much harm. But fiscal policy was tightened before private demand was strong enough to sustain the recovery, thereby entrenching deflation. The reductions in public works spending were introduced only shortly after the positive effects of fiscal support had registered within the economy. It had been the absence of an appropriate macroeconomic response to the financial crises of the early 1990s that had initially turned a cyclical recession into a prolonged economic decline. Thereafter, macroeconomic austerity combined with financial laissez-faire to put the country in greater trouble than many were willing to concede. By 1997 Japan faced falling demand, negative investment and declining profits, effectively ruling out any recourse to recession-driven structural reform.

The shadow of the 'lost decade'

Japan's economic and financial reversals in the 1990s caught international attention not so much because of its detail (graphic though it was compared to the country's stellar success in previous years) but rather because of the manner in which recession in the early party of the decade had been transformed into chronic stagnation towards its end, an experience not shared by countries which had similarly suffered banking and equity price collapses.

Most observers assumed that because of its searing experience Japan at the turn of the century would adopt radically different policies to regain at least some semblance of its former economic prowess. But although the ensuing decade did witness spurts of growth and notable manufacturing export successes, the country failed to discover a path to sustainable high growth. One major stumbling block was the failure of the authorities to learn the lessons of the 1990s. There was evidence enough of the need to act boldly in recapitalizing the banking sector; to sustain the confidence of investors in the private sector by being willing to sustain fiscal imbalances as a catalyst of growth sufficient to encourage corporations to take up the slack; to coordinate monetary and fiscal policy and to reduce the power of elite bureaucratic institutions to stymie policy by favouring particular industrial and agencies. And it was critical to attack deflation and to raise aggregate demand.

Until 2003 the Japanese economy performed disappointingly after the growth spurt at the turn of the century. By then the percentage growth rate of GDP had barely reached the level achieved in 1995. From 2003 to 2006 the average annual growth rate of real GDP in Japan (2.3 per cent) matched that achieved by the European Union during the same period and surpassed Japan's cyclical expansions of the late 1960s. Large (predominantly exporting) manufacturing firms were starting to embrace competition in the market place. They had rejected the post-war tradition of socializing risk and had embarked upon more market-oriented relationships with suppliers, banks and employees in order to become focused, innovative competitors.

Japan's economic recovery between 2004 and 2007 was underpinned by growth in exports, aided by a significant fall in the real value of the yen. For decades, however, Japan had neglected to address the fundamental problems of flagging demand and low productivity, especially in services and manufacturing for domestic consumption. Even when Japan's successful exporters had been earning substantial profits in the immediate past, increasing capital investment in cars, machine tools and electronics in particular, they had proved reluctant to expand wages. For many years, consumption had been supported by households running down their savings. The shrinking working-age population, the increasing reliance by corporations upon lower-paid contract workers, and the growing uncertainty among the ageing population about the future of public finances served thereafter to curb domestic demand and, with it, potential growth. Anaemic domestic consumption, however, meant that even moderate recovery remained heavily dependent upon export growth.

Japan's exposure to the substantial decline in export demand, following the international financial crisis in 2007–08, revealed how dependent the country was upon external developments over which it had little control. As the world financial crisis intensified, so did recourse to the yen as a 'safe' currency; this exposed the country to an asset-market driven currency appreciation, which threw Japan's growth into reverse. Because Japanese interest rates had been considerably lower than those in the USA and elsewhere between 2002 and 2007, the yen remained weak as investors converted the currency into dollars. The weak exchange rate helped drive Japanese economic growth but the export price advantage was lost after 2007, once USA interest rates began to fall and the yen started to appreciate. Such appreciation undercut the price competitiveness of Japanese exports and eroded the yen value of profits made overseas.

For all the enforced changes wrought upon Japan's economy in the wake of the 'lost decade', deflation, over-capacity, depressed domestic demand, and a rising public debt persisted. What was needed more than currency intervention was a pro-growth, pro-competitiveness agenda. However, shifting employment patterns during the 1990s had embedded low wage growth in a two-tier labour market. Uncertainty had continued to stymie domestic demand during the 2000s, just as low tax revenue from poor growth strained the ever-rising national debt. That remained Japan's dilemma. The shrinking labour force, combined with the fiscal burden of an ageing population, reduced Japan's trend growth rate to only 1–1.5 per cent. Given such projections of modest growth, direct action to improve revenue remained critical. Tax hikes, however, remained unpopular and, as was demonstrated in 1997, were likely to prompt further decline at a time when domestic demand was already weak.

Japan found itself under pressure to abandon a supposedly outmoded model of political economy long before it had seriously contemplated adopting a Western liberal market model as a viable or speedy option. Bureaucrats lacked any real conviction for free market economics and engaged in incremental rather than substantive reform. With the BOJ still convinced that deflation was the result of structural impediments rather than monetary policy, and with the MOF haunted by its earlier attempt to raise taxes before recovery was underway in 1997, there was little discussion of deploying a unified monetary and fiscal policy to encourage sustainable growth.

The sheer persistence of deflation had its own debilitating effect. Confidence had been severely shaken during the 1990s but, with nominal interest rates so low, deflation had delivered investors a risk-adjusted return. The significant rally in 10-year government bonds in 2005 – from their trough in 1990 – reflected how risk-averse the Japanese saver continued to be. Moreover, during the high-growth period, the 'losers' in society had been compensated through public works and other forms of subsidized lending financed from growth revenues. Two decades of slow growth made it more difficult to sustain previous levels of compensation. Workers, consumers and households, aware of the dramatic shift in circumstance, remained suspicious of any further radicalization policy which might weaken the underlying premises of the post-war social contract.

During the high-growth period, the trade-off between greater risk-taking, efficiency and stability had been relatively easier to accomplish because the risks were shared and their magnitude was lower than it subsequently became. Sluggish growth, low domestic demand and fiscal indebtedness remain immutable traits of post-1990s Japan. If the authorities wished to challenge the idea that Japan inevitably faced permanently lower growth rates, fiscal denouement and the eclipse of a younger generation's aspirations, they would have to have domesticated their political and economic systems with what has been termed 'open, non-destructive conflict' incorporating behavioural, institutional and political changes 'extensive enough to constitute a second miracle'. Did the inauguration of 'Abenomics' herald such a putative transformation?

Is 'Abenomics' the answer to Japan's secular stagnation?

We have drawn sufficient attention to the critical elements of Japan's post-war political economy to establish a central premise of this paper, namely that the institutional and ideational matrix constructed to deliver catch-up growth affected the content, direction and fate of economic policy in the ensuing decades. Since we are concerned with the issue of continued stagnation, it is worth examining in conclusion whether any aspects of Japan's past policy priorities will continue to hinder the path to sustained economic recovery outlined by 'Abenomics'. This policy mix, as is well known, has three principal elements: a more activist monetary policy for the BOJ, a fiscal boost via increased spending on the infrastructure in the medium term, and structural reform designed to raise long-term industrial productivity.

The Bank of Japan's objective is to increase the rate of inflation to 2 per cent so that companies and individuals can take advantage of negative real interest rates. BOJ purchases of long-term government bonds are meant to depress their yield and so spur banks and companies to seek higher returns elsewhere either by investing in the real economy or by investing abroad. Consumers are encouraged to revise their inflationary expectations: to spend now partly because hoarded cash will lose value and because consumables will be higher in price at a later date. Such proactive spending is expected to boost industrial profits thereby providing more money to spend and invest in a virtuous cycle of growth.

There are a number of fundamental problems with this current orientation of policy each of which mirrors the weaknesses of economic and financial policy in the troubled 1990s. It relies too heavily upon the effectiveness of monetary policy to be a driving force for sustainable growth; it is based on certain behavioural assumptions that are far from predictable; and it seriously neglects the role of demand.

One of the underlying presumptions of current Bank of Japan policy is that consumers will fear inflation more than they hate deflation and will be prompted to raise their consumption spending. But although luxury spending rose on the back of asset inflation during the early months of Japan's financial experiment there was little evidence of a 'wealth effect' creating spillovers from the increased value of financial stocks and shares. Many Japanese were not the direct beneficiaries of stock market gains. Retail figures revealed few signs of a massive peremptory spending spree.

Moreover the Bank's approach ignores the fact that people may not harbour such a negative view of deflation that it assumes. Purist economists are always keen to point to the scourge of deflation – it damages financial assets, boosts debt service costs, undermines confidence and corporate profits, and lowers tax revenue. But to those who suffered the surge in living costs in the 1970s and who as a greying population favour falling prices over rising ones deflation becomes a *symptom* of Japan's malaise – not its cause. Many players have adapted to a deflationary perspective – households who have for years sustained living standards without the expectation of regular wage increases, companies which also over the years have engaged in cost-cutting rather than fighting for bigger market shares, and governments which have willingly amassed massive debt in order to avoid destabilizing reforms. Turning this around will remains a fundamental challenge to the Japanese authorities.

In many important respects the assurances of action and reaction that figured prominently in the political economy of the high growth period no longer operate to sustain a collaborative effort at national economic rejuvenation. Many Japanese companies have not reacted in the ways anticipated by recent reforms. They seem to need reassurance that markets have indeed turned around before they are prepared to commit themselves to raising employment and increasing wages. From their perspective what Japan needs are demonstrably higher growth expectations rather than higher inflation expectations.

Consumer spending lies behind some 60 per cent of Japanese economic activity and it is the lack of increased wage/salary income that is affecting the potential contribution of rising demand to boost overall economic activity. As in Japan's past there remains a signal neglect of the foundations of strong domestic demand. Among those in the Japanese labour market hardest in recent decades is the rapidly expanding underclass of temporary workers. Their contracts (when they can obtain work) are frequently stripped of the benefits enjoyed by their counterparts during the era of breakneck growth: jobs for life, incremental pay rises and seniority-based promotions. According to a Labour Ministry survey in 2014 a record high of one in six Japanese lived in relative poverty due to falling incomes in families with young children and the rise of poorly paid, irregular jobs.

Beyond this deficiency is the additional fact that many small and medium-size enterprises and local economies are not reaping the benefits of massive monetary easing. Increases in the prices of food, gas, and electricity hurt the domestic consumer. Such price rises are the cause of what meagre inflationary impulses are officially recorded (and hastily advertised) but they are not the result of strong demand backed by wage increases. Nominal wages peaked in 1997 and have fallen on average thereafter due to restructuring and a marked shift in demand for cheap, irregularly employed labour. Businesses in short may be making increased profits from a monetary- induced yen depreciation but there is scant evidence of any 'trickle down' effect on consumer spending.

It was widely acknowledged in Japan from the 1970s onwards that structural reform could improve labour productivity in the longer term and form a basis for wage increases. But such reform has proved singularly laggard for many of the reasons outlined earlier. In the context of current Japanese policy businesses appear more content to build up internal reserves rather than to boost wages, thereby weakening the potential of a demand-induced cyclical recovery.

Demographics add a further dimension to worries about Japan's capacity to strengthen its global competitive position. Economists have calculated that the shrinking working-age population dragged down Japan's GDP growth by an average of just over 0.6 percentage points a year between 2000 and 2013.

An ageing population focuses attention on the role of demand. Because young people on the whole tend to buy more durable goods (cars, appliances) while older ones direct expenditure more towards services such as medical care and travelling aggregate demand during a demographic transition is often skewed toward the service sector relative to the manufacturing sector. Productivity in the non-manufacturing sector, however, has traditionally lagged behind that in manufacturing. Since Japan can ill afford any drag on its productivity performance it must seek out opportunities to affect the structure of demand even in the face of long-term shifts in the labour force.

Panel data of twenty OECD countries over the period 1960-1994 have indicated contrary to normal expectations that fixed business investment (especially in inventories) has tended to rise in countries with an increased share of older people. Japanese people aged 60 years or older account for at least 40 per cent of Japanese consumption and their share is projected to increase further. The most obvious demand for medical and care services provides an opportunity for increased investment in those and related fields which if more full exploited could contribute positively to the country's potential growth rate. In the decade or so since 2000 the population aged 65 or over increased 33 per cent in Japan and 16 per cent in the U.S.A. Spending on medical and nursing services during the same period increased by only 11 per cent in Japan compared to 74 per cent in the U.S.A.

Such data suggest a large potential opportunity for the private sector in Japan to invest significantly not only in the market for medical and nursing services but also in medical equipment and other health-related sectors. There are already developments afoot in high technology humanoid robotics to provide new advanced systems of care for the elderly as the size of the active workforce diminishes. There are beds that turn into wheelchairs, robot pets that respond to petting to help older people overcome the curse of loneliness, and intelligent toilets that have medical sensors to measure blood-sugar levels with data e-mailed to local GPs. The real challenge, however, is for Japan to promote greater foreign venture capital to foster developments in biotechnology (only one example) and to encourage a greater flow of information and talent from outside Japan.

Hopeful developments are often fraught with countervailing pressures. The stimulus to demand and consumption that might be expected from dissaving by the elderly, for example, could well be offset by rising precautionary saving among the very same group if they become fearful of the size of public debt and the government's commitment to social security pledges. In those circumstances, saving for one's own future might be regarded as a better option. And insofar as old age dependency reduces the consumption of an already dwindling cohort of younger workers because of the increased tax and social security burdens imposed upon them, adults of childbearing age might reduce fertility further in an effort to sustain living standards, thereby exacerbating the fundamental longer-term problem. Having a more productive young labour force would help but that begs the question of whether governments and firms have the educative/training programmes in place to effect such improvements.

Keynes's emphasis on sustaining domestic demand remains crucial to the argument. The approach has never been without its critics and they are virulent today. In a now celebrated paper Reinhart and Rogoff of Harvard University claimed that economic growth rates slow sharply when government debt tops 90 per cent of GDP. To Keynesians the obvious retort is that slow growth might be a cause of high debt rather than a symptom of it. It was discovered subsequently that Reinhart and Rogoff's findings had been underpinned by an analytical error and questionable data choices. What is more to the point is that there is no consensus among economists as to what level of debt harms growth.

The social, political and cultural complexities of Japan make it imperative that if the corporate sector is lackadaisical in providing stable and well paid employment then the government must act to sustain demand, even in the face of immediate budgetary pressure. When Keynes called for a 'socialization of investment; in the late 1930s what he had in mind was not a command economy but rather the willingness of government to use its fiscal strength (which it alone possesses) to sustain investment and demand until such time as the private sector gains the confidence to invest for growth. The reactionist view -that cuts in government spending are preferable because they will encourage a more confident private sector to expand investment is- to use Krugman's phrase a 'confidence fairy'.

Continued deregulation in Japan may eventually encourage companies to expand and to increase wages so that customers can spend more. But without efforts to sustain demand in the immediate term the government faces the prospect of rising prices and a public that sees inflation more as the result of cost-push rather than demand-pull and thereby threatening. Contrary to the hopes of the BOJ, expectations could fail to change enough to get the economy on an inflationary track that promotes rather than hinders growth.

A radical change in monetary policy through quantitative easing is not a sufficiently strong foundation in itself to foster sustainable growth. Reforms are needed to allow banks to lend more, employers to hire more on stable better paid contracts, and for new enterprises to be established to foster innovation and technological competitiveness.

Clearly a government like Japan's that is faced with a debt/GDP ratio of some 230% needs over time to reduce its structural fiscal deficit. But to do this the Japanese private sector needs in tandem to reduce its structural financial surpluses. Keynes would almost certainly have recognized that in the longer term the excess of retained earnings over investment must decline. Japan's private savings –almost entirely generated by the corporate sector – are too high in relation to plausible investment opportunities. Japan has been investing too much, not too little. It needs reform that lowers corporate savings such as altered depreciation allowances, a tax on retained earnings, greater empowerment of shareholders, greater investment tax credit all designed to help the private sector recover from the aversion to borrowing that was caused by the deleveraging that began in the 1990s and which lasted for 15 years as companies sought to repair their balance sheets rather than take up cheap money for investment. Tax corporate savings, not Japanese consumers! As Ronald Dore has argued, it is optimistic capitalists that are lacking, not cash.

A strong currency tends to foster structural reform or at least recognition of the need for it. But debasing the currency through enforced depreciation, as BOJ policy does, can often encourage companies to persist in bad habits as exports are subsidized by a cheap currency. Ultimately companies have to compete on value and not just price. Once a country comes to rely heavily on investment flows from abroad then budget deficits take on a meaning of their own. A 200% plus debt/GDP ratio becomes unsustainable unless the central bank monetizes the debt –which could lead to currency meltdown.

Japan lacks the 'gasoline of demand' to spark its engine into action. It needs a Keynesian approach to remedial policy if only to strengthen the potential effectiveness of monetary policy, to work alongside a strategy of targeted high multiplier fiscal spending. Only then can structural reform be initiated in ways likely to gain support in both the public and the private sector, especially since such reform will produce both winners and losers. Japanese authorities were aware of these issues decades ago but a combination of administrative, political, national and sectoral interests stalled overtly radical policy. The extent to which such institutional inertia persists will determine the immediate fate of the Japanese economy.

More generally the fight against secular stagnation across the industrialized world needs to embrace a number of key issues, namely the need: to monitor the balances of domestic saving and investment if demographic transitions are not to foster over-expansion of the former and under-performance of the latter; to use government spending to raise the level of targeted investment (sometimes in advance of the private sector) on a scale and for a duration designed to raise confidence in the potential for growth; to stimulate wages as a bedrock to sustainable domestic demand and as a key element in encouraging the private sector to undertake growth-orienting investment; to openly recognise the danger of unsustainable long-term public debt but without imposing self-defeating contractions of demand, incomes and jobs; to protect against the corporate and banking sectors diverting their energies to asset and profit protection if it hinders the operation of monetary and fiscal policy; and to recognise that protracted declines in wages, employment, public services (including health and education), and tax revenues are a recipe for greater fiscal burdens in the future.

There is ample evidence within Western Europe and beyond that chronic stagnation erodes not just the real economy but also the foundations of stable communities, family life, investment in human capital so vital to future viability, and confidence in authority. There is a sense of economic immorality afoot as the public sector is frequently called upon to compensate for the excesses of the private (predominantly financial) sector. Economists are criticized for not meeting the challenge, as are governments for putting national self-interest before co-ordinated international action. Japan is as yet unable to escape repeated contraction because it shirks from policies that seriously disturb the status-quo ante. Whither the fate of Europe?