Japan's economy: from the "lost decade" to Abenomics

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In the post-war period Japan's economy grew rapidly, averaging annual growth of 10% during 1955-1970, and around 5% in the 1970s and 1980s. Large bubbles developed in the property and stock markets in the late 1980s, the collapse of which led to sluggish growth in the 1990s, known as the "lost decade". Lingering effects of this were still felt in the 2000s, as a modest economic recovery in the mid-2000s gave way, as in much of the world, to a deep recession in 2008-2009. Recovery was set back by the March 2011 earthquake and tsunami.

The Japanese economy, the world's third economy, currently faces three main problems:

- **weak growth** over the past two decades, caused, in part, to structural problems;
- **deflation** (falling prices) which has become entrenched since the late 1990s and has had a harmful effect on the economy;
- the **high level of public sector debt**. A weak economy and repeated government stimulus plans have led to debt levels currently unparalleled among major economies. Gross debt stood at 238% in 2012 (compared to 90% for the UK).

A newly-elected government led by Prime Minister Shinzo Abe has embarked on a radical plan revitalise the fortunes of the economy. These policies have become known as Abenomics and can be grouped into three main strands:

- **monetary policy** – the Bank of Japan has dramatically expanded its quantitative easing (QE) programme, to be more aggressive in its attempts to end persistent deflation by injected more money into the economy;
- **fiscal policy** – a short-term stimulus designed to boost economic activity followed by a medium-term plan to reduce the large deficit and stabilise the level of public debt;
- **structural reforms** – a growth strategy for the longer-term made up of structural reforms to the labour market and deregulating some sectors of the economy.

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1 Background

In the post-war period Japan's economy grew rapidly, averaging annual growth of 10% during 1955-1970, and around 5% in the 1970s and 1980s.[1] Large bubbles developed in the property and stock markets in the late 1980s, the collapse of which led to sluggish growth in the 1990s, known as the "lost decade". Lingering effects of this were still felt in the 2000s, as a modest economic recovery in the mid-2000s gave way, as in much of the world, to a deep recession in 2008-2009. Recovery was set back by the March 2011 earthquake and tsunami.

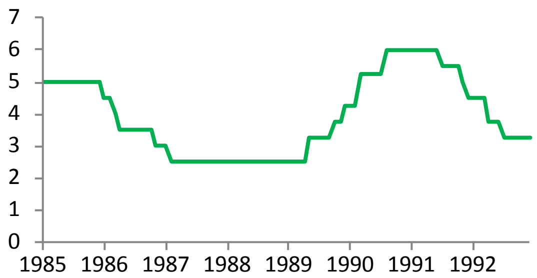
1.1 1980s boom and the bursting of the asset-price bubble

By the mid-1980s, imbalances among the world's leading economies led to a meeting of the G5 countries (Japan, USA, UK, France and West Germany) in New York in September 1985. The resulting agreement, known as the Plaza Accord,[2] saw coordinated interventions in foreign exchange markets to strengthen the currencies of Japan (yen) and West Germany (deutschemark) against the US dollar. This was done to try to reduce the relatively large trade surpluses in Japan and West Germany and reduce the trade deficit in the US.

In the following months, the yen appreciated sharply, rising by 46% against the US dollar by the end of 1986.[3] This made Japanese goods more expensive to buy on the international market and led to Japanese exporters, an important contributor to GDP growth, being adversely affected (exports fell by 5% in 1986). GDP growth slowed from 6.3% in 1985 to 2.8% in 1986. In order to mitigate these effects and to support growth, the Bank of Japan (the central bank) cut interest rates from 5.0% in January 1986 to 2.5% in February 1987.

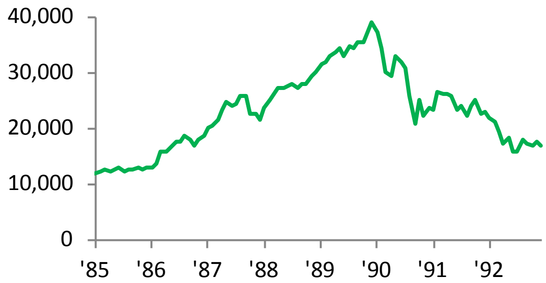
Official interest rate (%), Bank of Japan

Discount rate



Source: Bank of Japan

Nikkei 225 stock index



Source: Bloomberg, monthly data

Low interest rates, together with tax reforms that provided further stimulus, helped the economy to boom once again. Annual GDP growth averaged 5.5% during 1987-1990, unemployment fell to 2% and the government ran a budget surplus.

A strong economy, cheap borrowing costs and lax financial regulation helped to create bubbles in the property and stock markets. As interest rates were raised from 2.5% in May 1989 to 6.0% in August 1990, asset prices collapsed. The benchmark Nikkei stock index, which had risen four-fold in just six years to almost 40,000 at the beginning of 1990, abruptly lost half its value by October 1990 and fell below 15,000 in 1992. Land prices also fell sharply, by more than 50% from 1989 to 1992.[4]

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[1] Statistics Bureau of Japan, Historical Statistics of Japan: National Accounts, table 3.1 and IMF, World Economic Outlook (WEO) April 2013 database (used throughout this note for macroeconomic data)

[2] Named after the hotel in New York where the meetings were held.

[3] IMF, "Box 1.4: Did the Plaza Accord Cause Japan's Lost Decades?", *World Economic Outlook April 2011*

[4] OECD, *Economic Survey of Japan 2013*, April 2013, fig 8, p25 based on Ministry of Land data

1.2 1990s: the "lost decade"

Contrary to popular perceptions, Japan's so-called "lost decade" was not on-the-whole a period of economic contraction; GDP growth averaged around 1% per year. [5] However, as we have seen above, this was much lower than previous decades. In addition, long-lasting effects from the decade's financial crisis continue to plague the economy to this day.

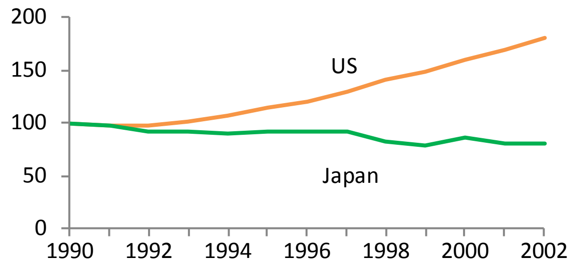
The bursting of the late 1980s property and stock market bubbles caused a banking and corporate debt crisis. The banking sector was saddled with a large numbers of non-performing loans (where borrowers had either defaulted or had difficulty making repayments). The extent of the problem was not well understood in the early to mid-1990s and banks, with the blessing of authorities, initially played for time through a policy of forbearance (giving the borrower more time to make up for overdue loan repayments), in the hope that an economic recovery would alleviate the problem.

With their approval, Japanese banks delayed recognising the full extent of their losses on non-performing loans. To do this, they continued lending to insolvent borrowers to keep them from filing for bankruptcy. The result was a further build-up of credit problems during the first half of the 1990s, with banks not recognising these losses and allowing "zombie" firms that were essentially insolvent to continue trading.

Keeping large amounts of bad loans on their books left banks reluctant to offer new loans to businesses or to take on risk until their underlying shortage of capital was resolved. The chart below shows how the size of bank balance sheets – which represents the total value of assets (largely loans) banks own – fell throughout the 1990s and early 2000s, in contrast to banks in the US, for example. Firms, meanwhile, chose to pay down their substantial existing debts rather than invest (a process which was made more arduous by Japan's negative inflation rate).

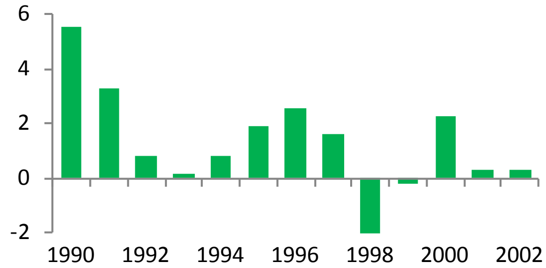
Despite repeated fiscal stimulus packages from the government (which contributed to an increasing public debt burden), interest rates being cut to near 0% and short-lived periods of recovery, the lost decade saw a decline in Japan's international competitiveness and constrained GDP growth, averaging 1.0% per year during 1991-2002, compared to the G7 average of 2.4%.[6]

Total bank assets
Index, 1990=100; for all banks



Source: OECDstat, end-year figures

GDP growth
% change on previous year



Source: IMF, WEO database

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[5] Analysis of Japan's economic history draws mainly on IMF, Working Paper WP/09/282 *'Lost decade' in translation: what Japan's crisis could portend about recovery from the Great Recession* and OECD Economic surveys of Japan from various years

[6] It's worth noting that although the unemployment rate did rise from 2% to 5% over the decade, this was still much lower than in many other of the world's leading economies.

1.3 2002-2007: recovery

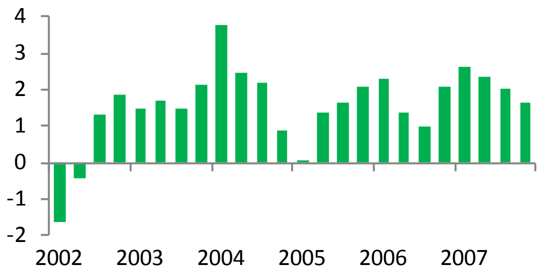
A more comprehensive approach to deal with the problems in the banking and corporate sectors was introduced in the early 2000s. These more assertive measures – such as using public money to recapitalise banks, better government supervision of the sector and speeding-up the process of dealing with bad loans – proved successful in stabilising the financial system. The amount of non-performing loans in major Japanese banks fell by over 70% between 2002 and 2005.[7]

The Bank of Japan formally shifted to a zero interest rate policy in early 1999 (the official rate was already at 0.25%) and followed this in March 2001 with the introduction of a quantitative easing (QE) programme, the first major economy to do this. QE, the creation of new money to purchase bank assets, was designed to boost the amount of money banks have, so that they could better absorb losses from the bad loans they were unwinding. In turn it was hoped that they would ultimately lend more to individuals and businesses.

The unorthodox policy of QE was also implemented to combat deflationary pressures in the economy: price levels had been falling slowly since 1998. By pumping more money into the economy, the plan was that price levels would be to rise again. The scale of the QE programme was expanded repeatedly up to 2004 as it was failing to have the desired effect and prices continued to fall.[8] As the economic situation improved and there were some indications that the period of deflation was coming to an end, the Bank announced in March 2006 that it would be ending its QE programme.

Quarterly GDP growth

% change compared to same quarter a year before



Source: OECD.stat

A healthier banking sector and a reduction in corporate debt levels supported an increase in business investment which, together with robust export growth, underpinned stronger economic growth from mid-2002 to 2007. Annual GDP growth averaged 1.8% per year in the five years from 2003-2007.

The improved performance of the economy helped lower the budget deficit as a proportion of GDP. A number of attempts to stimulate growth in the 1990s and early 2000s, and weak revenues from lacklustre economic activity had led to persistent large deficits. The deficit fell from 8% of GDP in 2003 to 2% in 2007.

1.4 2008-2009 recession and its aftermath

The consequences of the global financial crisis, particularly the sharp drop in world trade, caused the deepest recession in Japan's post-war history in 2008-2009, with GDP falling by 9%. A recovery in foreign demand led to exports rebounding strongly in the second half of 2009 and 2010. This, together with large government stimulus packages, led to GDP recovering most the output lost during the recession by mid-2010.

The Bank of Japan, like many of the world's big central banks, took a number of actions to help stabilise turbulence in the financial system, although the problems were less severe in Japan than in other countries such as the UK and US. With signs of a weakening economy in

[7] OECD, *Economic Survey of Japan 2006*, Aug 2006 , pp52-53
[8] For more on the negative consequences of persistent deflation in an economy see section 2.2 below.

late 2010, the Bank introduced a policy of “comprehensive monetary easing”. This included reducing the official interest rate to just above 0% and committing to keeping it there until “price stability” – inflation between 0 to 2% – was in sight (the recession had seen the return of deflation).

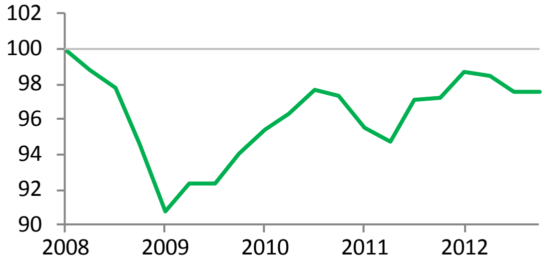
The programme also saw the return of QE, with the Bank of Japan creating money and buying mostly government debt previously held by financial institutions. With the additional money received from selling these financial products to the Bank of Japan, it was hoped banks would then be able to lend more to businesses and consumers. The scale of this new QE programme was ramped up a number of times by the end of 2012.[9]

The March 2011 Great East Japan Earthquake and resulting tsunami caused a large contraction in economic output, with GDP falling by 2.6% in the first half of 2011. Following the disaster, the government launched a 10-year reconstruction programme. Subsequent additional reconstruction spending has since been announced, with total planned spending of around 25 trillion yen (£180 billion).[10]

A rebound in GDP in the second half of 2011 and early 2012 gave way to another technical recession in mid-2012.[11] At the end of 2012 GDP was still 2.4% below its level before the 2008-2009 recession.

Real GDP since 2008

Index, Q1 2008 peak level of GDP = 100



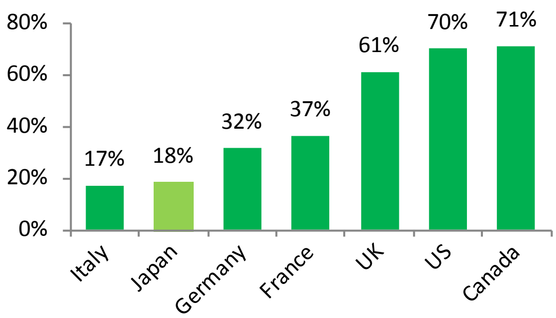
Source: OECDstat

2 Key issues facing the economy

2.1 Weak growth

Since the asset price bubble burst at the beginning of the 1990s, GDP growth has been sluggish, particularly compared to other major world economies. Although Japan is still the third largest economy in the world (after the US and China), GDP in 2012 was only 18% higher in real terms than in 1991, well below other G7 economies except for Italy.

Change in real GDP from 1991 to 2012



Source: OECD.stat

Looking ahead, a number of structural problems may hinder growth in the future. These include:

- a rapidly ageing population, with forecasts of a 40% decline in the number of working age people by 2050;
- some protected, uncompetitive sectors of the economy, e.g. energy, health care and agriculture; and

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[9] OECD, *Economic Survey of Japan 2013*, April 2013, pp19-23

[10] Throughout this note, yen have been converted into £ using the end-2012 exchange rate of Y140=£1.

[11] Defined as two successive quarters of falling GDP.

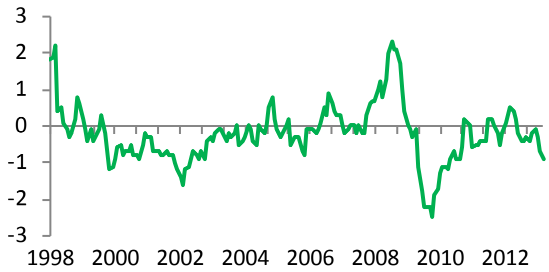
- the increasing segmentation of the labour market between regular workers – with generous rights – and non-regular workers – with fewer rights who tend to be part-time or on fixed-term contracts – on the other.

2.2 Deflation

Year after year of falling prices has had a harmful effect on the economy. Deflation has become entrenched. Consumers put off spending on some goods and services as they will become cheaper and businesses are discouraged from investing. This, in turn, has a harmful impact on GDP growth. Furthermore, deflation has led to falling wages (annual average wages in cash terms were 10% lower in 2011 than they were in 1997) putting additional downward pressure on consumer spending. Another harmful effect of deflation is that it increases real (inflation-adjusted) debt burdens. This is particular relevant for Japan, which has extremely large amount of public sector debt (see below). The chart above illustrates how deep-seated the deflation problem is.

Consumer prices

% change over same month in previous year



Source: National statistics agency, Japan

2.3 Public finances

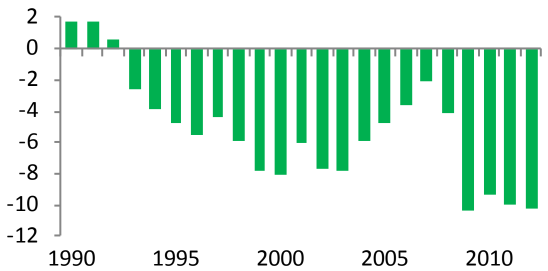
Over the past two decades, a weak economy and repeated attempts by government via fiscal stimulus packages to kick-start it, have led to very large deficits throughout most of this period. Between 2009 and 2012, the general government deficit has averaged around 10% of GDP. The cumulative effect of such large deficits over such a long time span has been a sharply increasing level of debt. Gross debt has risen from 67% of GDP in 1990 to an exceptionally large 238% of GDP in 2012. The equivalent gross debt figure for the UK is 90%.[12]

Despite such large levels of debt – currently unparalleled among major economies – Japan has never faced any difficulty in financing it or had a crisis of market confidence. In fact, Japan is able to borrow money at very low rates of interest, for three main reasons:

- “home bias” of Japanese banks and pension funds, who tend to keep their money within the country: over 90% of debt is held domestically;

General government budget balance

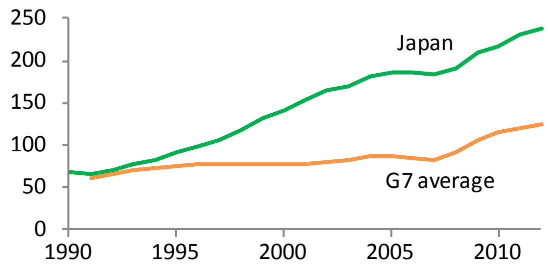
% of GDP



Source: IMF, WEO database

General government gross debt

% of GDP



Source: IMF, WEO database

[12] Please note that these figures are from the IMF and are calculated differently from figures published by national statistics agencies.

- the large pool of savings in Japan; and
- deflation means real (inflation-adjusted) interest rates are higher than the nominal rates paid.

Yield (%) on 10-year Japanese govt bond

Source: Bloomberg, monthly data

The chart opposite shows how low borrowing costs have been for the government. Indeed, despite gross debt more than tripling since 1990, the total amount spent on interest payments has actually fallen by 30% because of the much lower interest rates being paid.[13]

Despite these factors, because of Japan's large deficits and massive existing stock of debt, long-term fiscal sustainability has been called into question by many, including the OECD. In its 2013 economic survey of Japan stated it that "the [existing] equilibrium – large government deficits financed at low rates by Japanese savers – will not last forever".[14] It also warned that a "marked rise in interest rates" could threaten "a banking system that is highly exposed to Japanese government debt".[15]

3 Abenomics: Prime Minster Abe's economic policies

After being out of office for three years, the centre-right Liberal Democratic Party (LDP) won a majority of seats in the lower house elections of 16 December 2012. Shinzo Abe, the LDP leader, who made his policies for the revival of the economy the centrepiece of his campaign, became Prime Minister. Mr Abe was previously Prime Minister for a year between September 2006 and September 2007. In July 2013, the LDP and its coalition ally the New Komeito Party won enough seats in the Upper House elections to secure a majority, removing a potential obstacle to Mr Abe's reforms.

Prime Minister Abe's economic policies have become known collectively as Abenomics. They can be grouped into three main strands. The first is monetary policy: Mr Abe has vigorously pushed for the central bank, the Bank of Japan, to be more aggressive in its attempts to end persistent deflation mainly via a dramatic expansion of its quantitative easing (QE) programme. The second is fiscal policy, with a short-term stimulus designed to boost economic activity followed by a medium-term plan to reduce the large deficit and stabilise the level of public debt. The final part is a growth strategy for the longer-term consisting of structural reforms to the labour market and some sectors of the economy.

3.1 Monetary policy

The Bank of Japan (BoJ) has for most of the period since the late 1990s tried to end deflation (falling price levels) and stimulate growth in the economy. Policies such as cutting the official interest rate to "virtually zero" and quantitative easing (pumping newly-created money into the economy via banks) had by the end of 2012 failed to end deflation.

[13] OECD, *Economic Survey of Japan 2013*, April 2013, pp110-111
[14] Ibid., p39
[15] Ibid. p.10

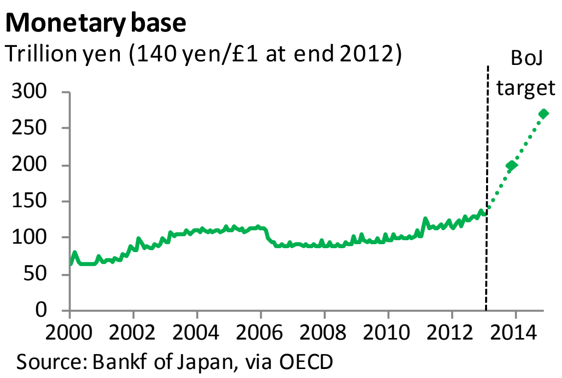
Prime Minister Abe is very critical of the BoJ's past efforts to end deflation and at times has threatened the BoJ's independence unless it implemented bolder policies, saying, for example, in late December 2012:[16]

> At this month's [December] policy meeting, the BOJ said it would examine (setting an inflation target) at its next meeting [in January] ... If it doesn't, we'll revise the BOJ Law and set up a policy accord with the central bank to agree on an inflation target. We may also seek to have the BOJ held accountable for job growth.

At its January 2013 meeting, the BoJ did announce a new inflation target of 2%[17] with the aim "to achieve this target at the earliest possible time"[18] but insisted the change in policy was a result of economic factors and not political pressure.

To implement more aggressive monetary policy, Mr Abe appointed Haruhiko Kuroda, as new governor of the BoJ. On 4 April 2013, the new governor announced significant new measures, dubbed by the BoJ as "qualitative and quantitative easing", the radicalism of which surprised financial markets. In order to lift inflation to its target of 2% in two years, the BoJ announced the following measures:[19]

- **Doubling of QE in the next two years.** As a result, the monetary base will go up from 138 trillion yen (£1 trillion) at end-2012 to 270-trillion yen (£1.9 trillion) at end-2014.[20] This is an increase from 29% of GDP in 2012 to 55% in 2014, or a rise of about 1% of GDP every month. Most of the increase will be via purchases of government bonds (in other words government debt).[21] This is the "quantitative" element of the policy.



- More than **doubling of the average maturity of government bonds purchased** from 3 to 7 years. In other words, the BoJ will be buying longer-term bonds than it has done in the past (including 40-year bonds). This is the "qualitative" part of the policy. The intention is that by buying longer-dated bonds from banks and taking them off the market it will:

  (i) force banks to seek riskier investments, by either supplying more loans to individuals and firms or by buying other assets (such as shares) either in Japan or abroad; and

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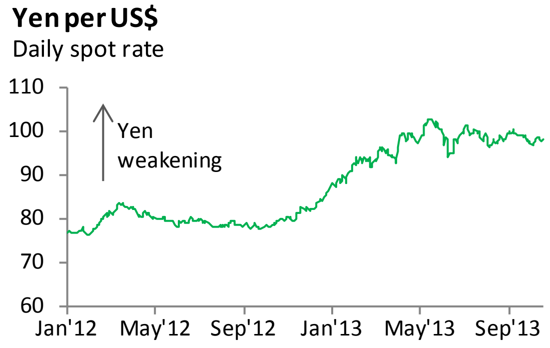
[16] For example: Reuters, "Japan's Abe heaps pressure on BOJ to set 2 percent inflation target", 22 Dec '12
[17] Annual change in consumer prices.
[18] BoJ, "Introduction of the "Price Stability Target" and the "Open-Ended Asset Purchasing Method"" [PDF], 22 Jan 2013
[19] BoJ, "Introduction of the "Quantitative and Qualitative Monetary Easing"" [PDF], 4 Apr 2013
[20] The monetary base is the sum of cash in circulation in the economy plus deposits of commercial banks with a central bank.
[21] The BoJ explicitly stated that these large-scale purchases of government bonds were "not for the purpose of financing fiscal deficits" but for the purpose of conducting monetary policy.

(ii) drive down longer-term interest rates as a result of this additional demand for these bonds, which may increase demand for loans from individuals and firms, potentially boosting growth.



Source: Bank of Japan

A key element to these measures is psychological: to break the vicious cycle of deflation creating the expectation of deflation in the future, which leads to deflation continuing. Another aspect is that expanding the money supply and encouraging money to flow abroad is likely to weaken the value of the yen, thereby making Japanese goods cheaper to foreign markets and, in turn, boosting exports. Since late 2012 when the prospects of Mr Abe's of becoming Prime Minister became very likely, the yen began to depreciate (see chart above). This continued in early 2013 as it became clear that a large QE expansion would be implemented.

One of the dangers of this policy is that by massively expanding the amount of government debt the BoJ holds, market confidence in the government's commitment to tackling the debt problem could be undermined, leading to rising interest costs on government borrowing and the negative consequences that entails for both the deficit and banks holding these bonds (see section 2.4).

3.2 Fiscal policy

Shortly after taking office, the government in January 2013 announced a fiscal stimulus package totalling over 10 trillion yen (£75 billion), equivalent to 2.2% of GDP, consisting of three main elements:[22]

- additional funding for reconstruction from the 2011 earthquake and disaster prevention measures such as strengthening infrastructure (37% of total);
- encouraging business investment and measures to help small businesses (30%); and
- social spending and money "revitalising the regions" (30%).

The government has preliminarily estimated that the stimulus will boost real GDP by 2% in total and add 600,000 jobs.

The rationale behind this move is to provide a short-term boost to the economy, while a structural reform plan, which will take longer to implement but have longer-lasting effects, is developed (see below).

Critics point out that many similar plans such as this which involve large-scale public-works projects have been tried before in Japan (the OECD states there were 15 such plans between 1990 and 2008). They argue that it will only provide a temporary boost to the economy while adding to the already massive stock of public sector debt (gross debt is about 240% of GDP).

[22] Cabinet Office, "Emergency economic measures for the revitalization of the Japanese economy", 11 Jan 2013

Acknowledging the scale of the fiscal challenge, the government has sought to secure confidence in the nation's fiscal sustainability by promising to deliver a credible medium-term fiscal plan. It has committed to halving the primary deficit – the budget deficit excluding debt interest payments – by 2015 compared with 2010 and to eliminate it by 2020.

The government has agreed to implement previously-approved rises in the consumption tax rate (a value-added tax) from 5% to 8% in April 2014 in an effort to reduce the deficit.[23] The tax rise will provide additional revenues of about 8 trillion yen (approximately £50 billion) a year.[24] The move is controversial given the last time the consumption tax was increased in 1997 the economy fell into recession. In order to mitigate against a repeat performance, Prime Minister Abe announced an economic stimulus package worth around 5 trillion yen (approximately £30 billion). This includes public-works spending in preparation for the 2020 Olympic Games in Tokyo, corporate tax cuts and tax breaks to promote private sector investment.[25] There is a concern from some quarters that the watering down of the consumption tax rise undermines the credibility of the government's commitment to fiscal sustainability.[26]

3.3 Structural reforms

The final component of Abenomics is probably the most important over the longer-term. Aggressive monetary policy and short-term stimulus measures may provide a temporary boost to the economy, but, given past experiences, many believe only by tacking structural problems will Japan's economy be able to reverse two decades of underperformance.

The government has announced some steps it intends to take as part of its "ambitious growth strategy" following reports in mid-2013 from committees looking into possible reforms. In June 2013 Prime Minister Abe made a speech presenting an overview of the strategy, which included:

- increasing the number of female workers (particularly mothers by improving availability of childcare) and younger people in work; and
- deregulating certain sectors, such as energy and health care, that are viewed as protected and uncompetitive. For example, plans have been announced to legalise the sale of non-prescription drugs.

The speech and subsequent announcements have been viewed by some as underwhelming and lacking in detail.[27] For instance relaxing strong job protection laws do not appear to be part of the strategy at this stage. Mr Abe, in an interview with the *Financial Times* in early October, stated that the "Japanese people are very sensitive" to redundancies and reforms to labour protection laws would take more time to explain to the population. He did emphasise the government's commitment to structural reforms and hoped to pass some legislation creating deregulated low-tax zones in urban commercial areas by the end of 2013.[28]

Also part of the growth strategy is the government's decision to join discussions on setting up a free-trade area for 11 countries (including the US but not China) bordering the Pacific

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[23] It is scheduled to rise again to 10% in October 2015.
[24] Reuters, "In historic step, Japan PM hikes tax; will cushion blow to economy", 1 Oct 2013
[25] Reuters, "Factbox - Japan unveils $50 billion stimulus to cope with tax hike", 1 Oct 2013
[26] *Financial Times*, "Japan's Shinzo Abe reveals tax plan as business confidence soars", 1 Oct 2013
[27] For example, see *The Economist*, "The third arrow of Abenomics: misfire", 15 Jun 2013
[28] *Financial Times*, "Shinzo Abe warns of delay in key labour reforms in Japan",6 Oct 2013

Ocean. The Japanese Cabinet Office has estimated that joining the Trans-Pacific Partnership (TPP) could boost Japanese GDP by 0.7% in a decade.[29] Reports from October 2013 suggest the talks are going well, although there is some resistance in Japan from certain industries, particularly agriculture, to the possibility of lowering import tariffs on some commodities including rice (where import tariffs are currently about 700%).[30]

While these moves are welcomed by many economists, some are concerned that the government's rhetoric may not be matched by its actions. Many of these reforms will be fought aggressively by powerful groups such as the medical lobby and farmers (who fear the opening up of trade via the TPP will be detrimental to their industry), seen as traditional supporters of the Prime Minister's party, the LDP. For instance *The Economist*, in favour of structural reforms, has in the past highlighted its concern that if monetary and fiscal stimulus provides a short-term boost to the economy, the government may shy away from tackling these sensitive structural issues.[31]

[29] Cabinet Office estimate of the economic effect of joining the TPP [in Japanese], Mar 2013
[30] *Financial Times*, "Japan politicians criticise Shinzo Abe's trade pact push", 14 Oct 2013
[31] *The Economist*, "Japan's economy: Keynes, trains and automobiles", 12 Jan 2013 and *The Economist*, "Japan and Abenomics: Taxing times", 5 Oct 2013