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JAPAN'S ECONOMIC STAGNATION. FROM ECONOMIC "MIRACLE" TO "STUMBLE"

1. Stages of development of the economy of Japan

In the early 90s of the 20th century Japan, after more than four decades of very high dynamics of development and the expansive growth of export, and then capital goods, entered a phase of stagnation and decline in the importance of the existing factors of expansion and stability.

A fall in growth dynamics and a worsening economic balance had made it that in the 90s Japan lost its leading position in the international competitiveness. The direct causes of the economic stagnation in Japan were: strong appreciation of the yen (Endaka), speculation ("bubble economy") and the phenomenon of relocation of production capacity abroad ("hollowing out"). After a period of speculation, the Japanese economy suffered stagnation, which was accompnied by a dramatic fall in GDP growth, stock quotes, real estate prices, and also the transfer of production capacity abroad.

From the viewpoint of the development dynamics of Japan, the period after World War II can be divided into several phases (Bossak, Bieńkowski, 2004, pp. 323-324):

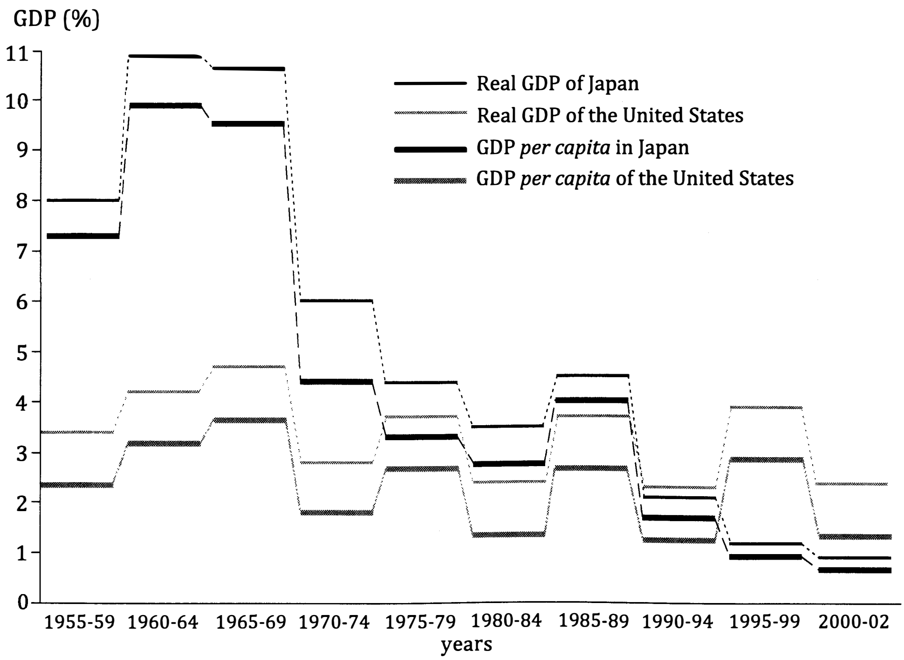
- post-war system reforms and structural changes (1945-1954);
- expansion and growth of the international competitiveness of the country (1955--1974);

- adjustment and liberalization of foreign economic relations and strengthening of the international competitiveness (1974-1989);
- economic stagnation ("lost decade") and the decline in international competitiveness (the 90s);
- structural reforms (after 2002).

The post-war period (1945-1954) was characterized by the American occupation, demilitarization and the restoration of civil liberties, the adoption of democratic and peaceful constitutional reform, de-monopolization of the economy, and with the outbreak of the Cold War – the introduction of stabilization and reform program conducive to economic development.

During the period 1955-1974 Japan entered a phase of accelerated growth and catching up development. With the high rate of GDP growth, which during 1955-1959 was 8%, during 1960-1964 – 10.9%, and from 1965 to 1969 – 10.6% and an increase in real GDP per capita of 7.29%, 9.92% and 9.50% respectively, in the mid-70s Japan closed the development gap separating it from other developed societies (Figure 1).

Figure 1
GDP growth (real and *per capita*) in Japan and the United States
between 1955-2002

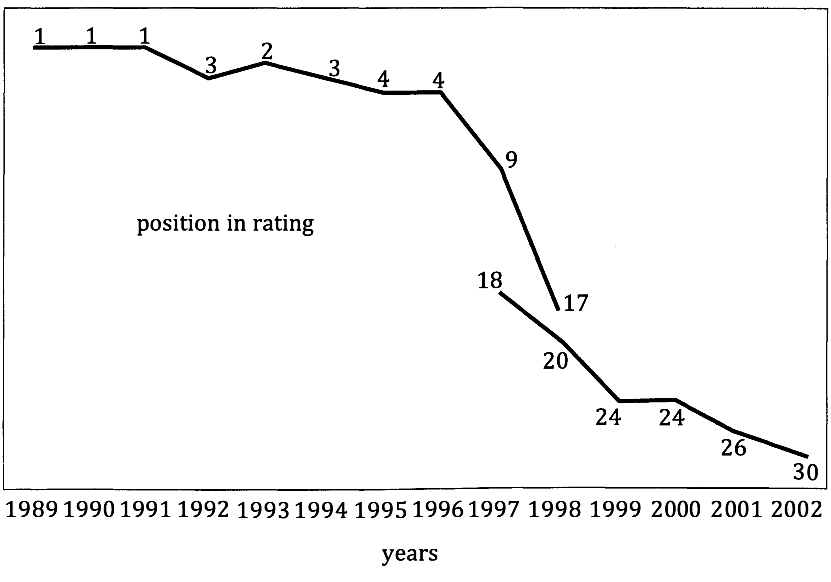


Source: Campbell (2004, p. 804).

The relatively smooth progress of the adjustment of the Japanese economy to the global energy market and the changing conditions and sources of competitive advantage in the second half of the 70s, allowed the gradual liberalization of the economic system, including the withdrawal of the state from an active industrial policy. In 1975-79 the average annual real GDP growth was 4.4%.

After a period of strengthening of the international competitiveness of the 80s, Japan had entered a phase of drastic reduction in economic growth which, due to the scale and the length, goes beyond cyclical decline in a single cycle. The Japanese economy experienced stagnation when the United States experienced a revival of investment, employment growth and productivity and technological modernization. The United States through deregulation, privatization, restrictive monetary policy, limiting of fiscal policy seized the opportunities connected with information and communication technologies (ICT). System reforms increased the efficiency of the market mechanism, stimulated innovation and competitiveness and a higher degree of utilization of productive resources.

Figure 2
The changes in Japan positions in IMD World Competitiveness rating in years 1989-2002



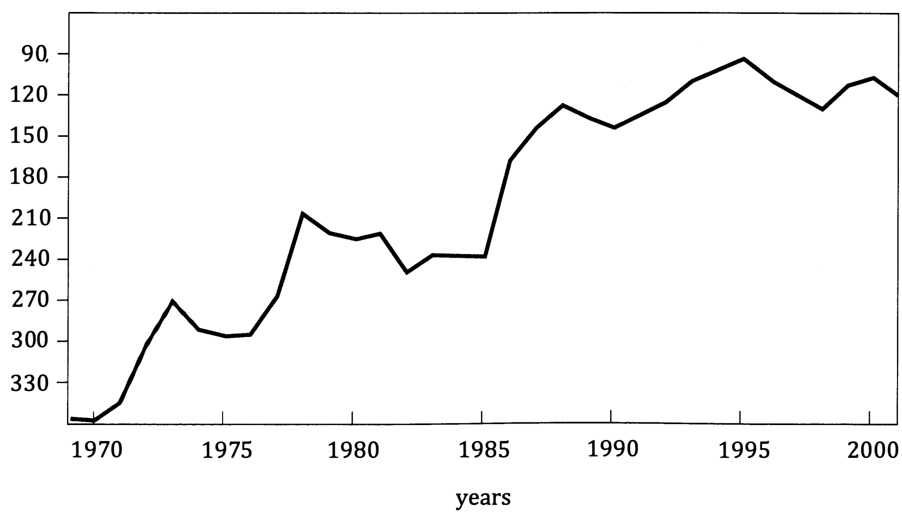
Source: *World Competitiveness Yearbook*, IMD (various yearbooks).

In Japan, since the 70s comprehensive reform of the socio-economic development has not been carried out, including in particular the financial system and the traditional capital-industrial groups Keiretsu (Grabowiecki, 2002). Japan in the 90s was characterized by institutional arrangements typical of the period of catching up development and closing the economic and technological gap. As a result, it lost its leading position in the international competitiveness (Figure 2).

2. The direct cause of economic stagnation

In the second half of the 80th key influence on the economy of Japan had the consent to the appreciation of the yen against the dollar (Plaza Accord) and the liberalization and deregulation of the financial system. As a result of arrangements made at a meeting of finance ministers and central bank governors of the G-5 group of most developed countries in September 1985 within the Plaza Agreement, the exchange rate policy was changed. Within two and a half years, i.e. between October 1985 and May 1988, there was over 100% appreciation of the yen, from around 255 yen per dollar to 125 yen, and in subsequent years the rate ranged from 100-125 yen per one dollar (Figure 3). At that time, the so-called strong yen syndrome appeared, for which the Japanese coined the term Endaka.

Figure 3
Changes in the exchange rate between the yen and the dollar during the period 1970-2000 (%)



Source: Mikuni, Murphy (2002, p. 12).

Radical appreciation of the yen led to a decrease in price competitiveness of export and its profitability. Higher export prices in dollars were not able to compensate for the decline in its dynamics and volume. This was accompanied by significant cheapening of the cost of imports, especially energy and raw materials and competitive import.

The strong appreciation of the yen had a deflationary impact on the Japanese economy since it contributed to a decline in investment and financial liquidity deterioration in business. In addition, it stimulated competition from cheaper imports, reduced margins and profitability of enterprices. It also caused a decline in investment in the domestic industry. Under conditions of lasting high levels of domestic savings and reducing of investment demand the so-called accumulation surplus appeared which caused a decrease in the real interest rate and an increase in the attractiveness of Japanese capital investment abroad. As a result, there was a rise in exports of capital and direct investment.

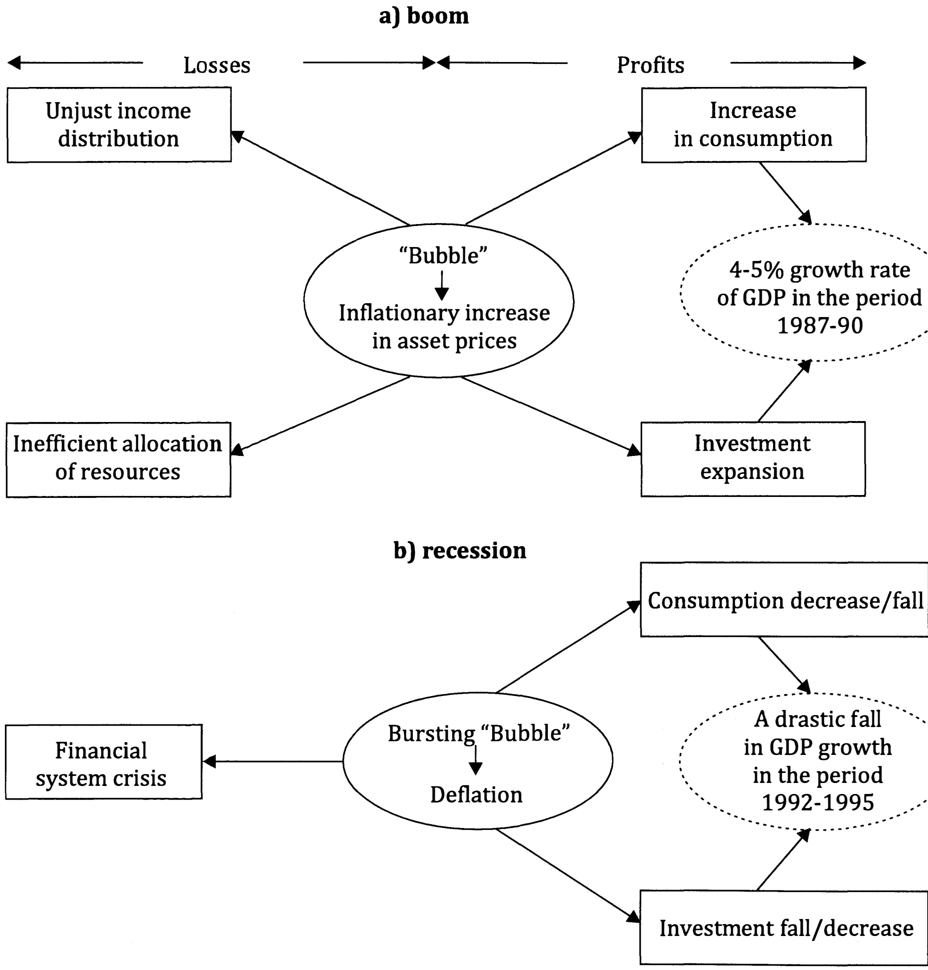
The strong appreciation of the yen was accompanied by a speculative boom. The fall in investment demand, apart from a growth in capital exports, was offset by an increase of speculative investment in real estate. Notwithstanding high land prices in Japanese metropolitan areas, they were still rising. In the metropolis, land prices in 1985 rose on average by 12.5%, in 1986 by 48.2%, in 1987 by 61.1%. In Osaka and its surroundings this increase was even greater because during the period 1985-1990 land prices had increased more than threefold. The investment of this type attracted financial institutions and industrial and capital *Keiretsu* groups.

With the passing of time, real estate became the subject of speculation on the stock market, which was caused by relaxing of monetary policy. Monetary authorities to prevent the appreciation of the yen reduced the discount rate to its lowest post-war level of 2.5%. As a result, during the period 1986-1989, money supply grew at a rate of 7.5-11.5%, while real GDP growth rate was 4-5%.

Expansion of capital abroad and speculation on the property market was accompanied by a sharp increase in listing of Japan's biggest corporations. By the end of 1989 the Nikkei 225 Stok Index reached a level of 915 yen in 1938, i.e. over three times higher than in September 1985 (12 755 yen), and the turnover on the Tokyo stock market was approximately three times larger than on the New York Stock Exchange. Japanese economy entered a phase commonly known as the "bubble economy" (Figure 4).

Changing of the stance of monetary policy by the Bank of Japan in the direction of tightening their policy in May 1989 and the associated increase in the discount rate from 2.5% to 6%, and the introduction of additional regulations on loans to purchase real estate, led to violent bursting of the speculative bubble. By October 1990 the value of the Nikkei 225 Stock Index declined by about 50%. Declines in property prices were not so violent and were spread over a period of time. The largest price reduction included industrial property in major Japanese cities. In 1997, their level was only 20-30% of the value of 1991.

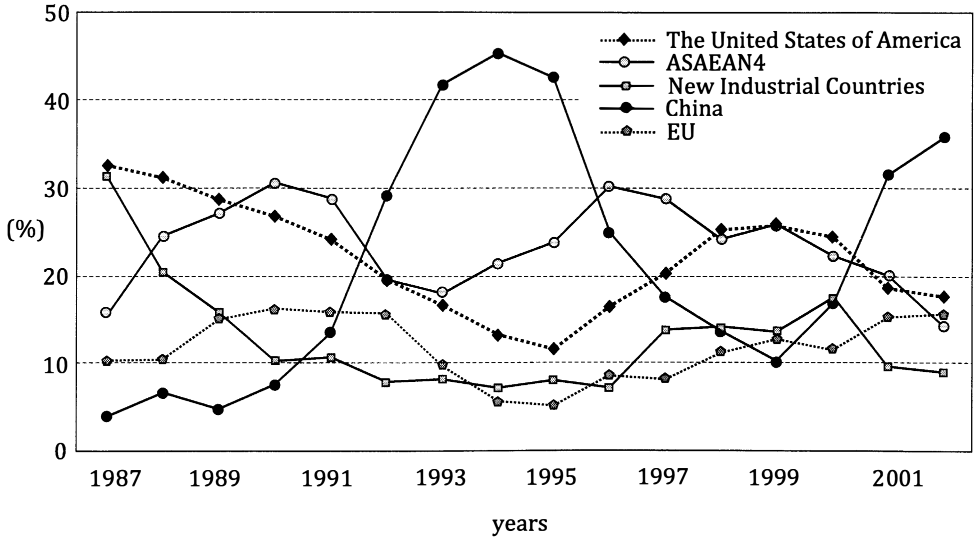
Figure 4
A "Bubble Economy" in Japan



Source: own study based on the Ishi (2000, p. 85).

Changes of sources of competitive advantage due to the energy crisis and changes of the terms of trade in the 70s and radical appreciation of the yen in the second half of the 80s launched the process of transferring of part of the production capacity abroad, and thus "deindustrialization" of the country (hollowing out). This phenomenon affected industries which lost their previous competitive advantage. The area of the Japanese economic expansion became first of all East and South-East Asia (Figure 5). Big investment projects lead to the development of local production of subassemblies, spare parts, components and final products. Much lower unit labour costs and an increased share of local supply production lead to a fall, and sometimes loss of exports of final products and the demand for sub-suppliers' production in Japan itself. Some vertical *Keiretsu*, i.e., *Matsushita*, *NEC*, *Sony*, *Sanyo* or *Toyota* launch overseas production of their products. This applies especially to the electrotechnical production, domestic appliances and automotive industry. Traditional Japanese sub-suppliers within the framework of *Keiretsu* structures are replaced by sub-suppliers from China, new industrial countries, and the ASEAN countries (Beamisch et al. 2001).

Figure 5
Changes in the activity structure of Japanese companies abroad in 1987-2002



Source: Yoshida (2004, p. 1)

Small and medium-sized enterprises in Japan itself are isolated from the existing customers. In a situation where the main contractors move the production to transnational networks, they note a decline in orders and a decrease in the rate of profit. There is a growing number of bankruptcies and the unemployment is growing. An increase in the value of contracts in companies outside Japan leads to a decline in demand and a crisis which affects companies operating within the *Keiretsu* groups. The organizational structures which had developed during the period of accelerated growth undergo disintegration (see Cowling, Tomlinson 2000).

3. The crisis of the banking system

Japan's post-war financial system had been under a strong influence of economic authorities, particularly the Ministry of Finance and the Bank of Japan. The main instruments of monetary policy included: artificially lowered interest rates, administrative rationing of credits and administrative management (*gyoseishido* practice). Conducted to the end of the 80s a policy of administrative setting of interest rates for all market participants at a level lower than market values, had enabled Japanese corporations to access cheaper loans than under full market conditions. This instrument was a kind of credit subsidy granted to Japanese corporations, including primarily *Keiretsu*. Administrative rationing of credits by the Bank of Japan up to the early 90s was based on determining an acceptable level of lending in a given period, whereas the limits were determined by defining the maximum growth rate of the loan portfolio relative to its value in the previous period. An instrument of an informal nature, following the form of administrative management, which introduced into the Japanese system opacity and arbitrariness, was regulation of branch networks and control of product strategies of financial institutions (Majewski, 2007).

The Japanese financial system used to function under conditions of isolation from global financial and capital markets. In practice, companies were prevented from access to foreign capital, and households from more favourable placement of savings. The autarkic system prevented the Japanese market from being penetrated by foreign entities. Gradual liberalization of capital flows from abroad began in the mid-80s and was completed in 1998 with the adoption of the new Law on Foreign Exchange.

An important instrument of the Japanese monetary authorities' interference in the mechanism of functioning of the financial system used throughout the whole second half of the twentieth century was the strict control of risk in the banking sector and the active management of the crisis. The policy of the Ministry of Finance sought to prevent bankruptcies of financial market actors. In the event of financial difficulty with any of the banks, the ministry started multi-stage rescue procedure, which in practice meant the acquisition of weak banks by banks whose financial situation was good. "Convoying of banks" was discontinued with the loss of most of the tools by which ministry officers could affect market participants and with an increase of the independence of banks. This became evident at the end of 1997 when it came to the first since the 20s bankruptcies of Hokkaido Takushoku Bank and Yamaichi Securities brokerage house, and in 1998 of Long-Term Credit Bank (Majewski, 2007).

The specific structure and nature of the Japanese financial system had repercussions for the whole economy, also it also had its serious implications for the banking sector, enterprises and households. During the post-war period the financial system had provided funding for an accelerated growth based on an investment expansion and export development. Under conditions of inadequate capital accumulation and marginalization of the importance of capital market, the financial system based on banks contributed to a smooth transformation of state-mobilized household savings into cheap and readily available investment and working credits for enterprises within the framework of the industrial policy. This enabled the expansion of investment and the distribution and control of risk, and, consequently, a growth in the economy lasting up to the end of the 80s (Majewski, 2007).

Starting from the 80s, the financial system gradually stopped responding to internal and external development conditions of the Japanese economy. The relaxation of control of the financial market in the late 80s and its full external liberalization in 1993-1995, marked the acceptance of international rules of the Bank for International Settlements to create bank reserves, capitalization, claims, and to increase the autonomy of the Central Bank. These changes were not accompanied by the creation of effective prudential regulations for its harmonious transformation. Banking supervision, exercised by the Ministry of Finance, for most banks was not based on precise, clear rules of supervision, but on the instructions and administrative guidelines for use in relation to individual difficult cases. This encouraged moral hazard, in which banks facing higher risks were expecting that, in an emergency, the Ministry of Finance would come with help and cover any losses (Majewski, 2002).

The liberalization of the financial market for the banking sector resulted in changing the profile of potential borrowers from large and well-known to the banks companies that had begun to benefit from external markets, to small and medium-sized, so far unknown. Credit decisions of banks based on an analysis of credit standing, gave way to permitted by law safeguards covering the value of the loans. The most attractive type of loan security remained the property whose market value increased gradually. For this reason, banks were willing to give loans to companies associated with the real estate market.

Along with joining in 1986 of the Bank of Japan the concerted action of interest rate cuts of G-5 central banks there was a significant increase in the attractiveness of credit in Japan (Tatewaki, 1991, p. 25). Between 1986 and 1989 the Bank of Japan reduced the rediscount rate from 5% to 2.5%. Liberalisation and deregulation of the market and the easing of monetary policy became the impetus for the speculative growth on the capital and real estate market.

A change in the stance of the monetary authorities' policy aimed to make the monetary policy more restrictive led at the end of 1989 to a slump in asset prices on the market. Real estate prices did not fall so drastically as stock prices, yet the process of reduction of their value continues. In this way the value of loan security underwent rapid erosion, the financial situation of borrowers, mostly related to real estate, such as trade, construction and distribution of building materials worsened. Similarly, the situation of Japanese banks deteriorated.

In the mid-90s, the economic situation in Japan was adversely affected by a crisis in non-banking financial institutions providing loans for the development of housing, i.e. *junsens*. The collapse of the real estate market drastically worsened the financial situation of these institutions (Milhaupt, West, 2004, pp. 1985-1986). Insolvency of financial institutions, banks or non-banking institutions connected with the system is a major concern for the stability of the financial system and the economy in Japan.

The collapse of the capital market made the Japanese economy fell into a "vicious circle" of pessimistic expectations. The fall in prices of securities and real estate made the situation of companies and financial institutions worse. Companies limited their investment activities and financial institutions their lending activities. The growing demand gap deteriorated still pessimistic expectations of economic agents and the public concerning economic developments. As a result, there was a further reduction of investment and credit which, in turn, caused the inhibition of the money supply and disclosure of deflationary trends. The adverse indicators of money supply growth rates led to further revision of even more pessimistic expectations. Japanese economy was "trapped" in a deflationary spiral of expectations leading to ever more rapid decline in prices and increased propensity to save. Thus, the situation of many banks worsened. According to estimates, the cumulative losses of banks amounted to more than 65 bn yen, which represents approximately 12-13% of GDP (Table 1).

Table 1
Situation in the Japanese banking system in 1992-2001

Specification	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Inflation rate (%)	1.4	0.5	-0.1	-0.5	-0.8	0.7	-0.5	-1.6	-1.9	-1.2
NIKKEI 225 Stock Index	18591	19111	16139	21406	18003	16527	15836	20337	12999	11024
ROI in industry (%)	3.3	2.5	2.8	3.0	3.5	3.2	2.5	3.1	4.2	-
The rate of return of banks' capital (%)	0.20	0.12	0.03	-0.54	-0.16	-2.01	-3.71	0.16	-	-
Risky loans/credits (in billions of yen)	12.8	13.6	12.5	21.9	16.4	22.0	20.3	19.8	19.3	27.6
Bank losses due to bad credit (in billions of yen)	1.6	3.9	5.2	11.1	6.2	10.8	10.4	5.4	4.3	7.7

Source: Miyajima, Yafesh (2003, p. 25).

The banking system crisis caused that they were heavily exposed to the market risk as they have a significant share of enterprises in their portfolios, i.e. about 10% of total assets. Until the collapse of the asset market, shares reinforced the position of the banks, now they constitute a major threat. The sales of shares, however, seem impossible because of the ties developed within the Keiretsu. Banks were thus in a situation in which they are forced to maintain enterprise shares (known as *zombies*), supporting their persistence on the market because it provides survival for the baks themselves. Banks' attempts to get rid of majority shareholdings of large firms from Keiretsu structures might have pushed some of them toward bankruptcy by unsettling the rate of shares.

In 1992-2000, successive governments prepared fifteen anti-crisis packages totalling about 115 bn yen (more than 1 bn dollars) aimed mainly at developing of infrastructure. These packages offered new jobs; at the same time, they were also the spur for economic development. However, they did not lead to a clear, sustained economic recovery. In 1996, a number of conditions indicated that the economy had risen from stagnation when the growth rate of GDP reached 3.9%. However, a premature tightening of fiscal policy, including raising the consumption tax from 3% to 5%, increasing the amount of social security contributions and reduction of temporary relief from income tax led to the deepest collapse in the the post-war history of Japan. Between 1998 and 1999 there was a decline in GDP growth which amounted to -2.9% and -1.3% respectively (Majewski, 2002, p. 20).

Anti-crisis packages introduced by the Japanese government in the 90s came down to stimulation of economic activity with Keynesian conventional methods. The problem, however, was that the investments under the budget investment loans programme (FILP) were characterized by low efficiency and, consequently, led to over-investment in infrastructure. Thus, attempts to revitalize the economy ended up in a further increase in budget deficit and national debt.

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In the early 1990s, the Japanese economy entered a period of decline in the importance of existing factors of expansion and stability. The post-war institutions and structures, which had played a positive role in supporting the expansion aimed at bridging the development gap in terms of post-industrial development, largely lost their previous usefulness. In many cases, they became a burden, and at times a brake on development. As a result, the Japanese economic model as a model for countries of South-East Asia substantially devalued. Economic stagnation in Japan, together with simultaneous successful Chinese economy made the countries of South-East Asia wonder whether it was still worth emulating the Japanese model or perhaps the Chinese model was more efficient.

Japan has exhausted its current momentum and growth potential and has no concept of how to reform its institutions. The high level of mobilization of resources and vocational activity, perfection of operational management and harmonious relations in the workplace do not provide effective mechanisms for adjustment of the economy and businesses to the requirements of global competition and innovative development. Nevertheless, the Japanese economic model may still be a model for countries of South-East Asia. When Japan's expansion of trade had begun to threaten the global balance of payment, it decided to make changes to the existing social model. It developed a social security system and significantly reduced the number of working hours. Spending on environmental protection and improvement of living conditions in major cities increased dramatically. Consequently, despite a drop in economic growth and income, the quality of life of the Japanese has improved decidedly.

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