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Lost Decades of Japan

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Abstract

In this paper, I have attempted to understand the underlying factors that led to the sustained stagnation of the Japanese economy from 1991. It covers the causes of the bubble that emerged in 1980s, the government's intervention to slow the over heated economy down, and then government's failed effort to revive it by implementing countercyclical stimulus policies.

The Lost Decade is referred to the time after the asset price bubble's collapse within the Japanese economy; the economy gradually slid into recession and has not yet recovered. The term originally referred to the years 1991 to 2000, but recently the decade from 2001 to 2010 has also been added, the combined period of 1990-2010 is coined as the Lost Years or the Lost Decades of Japan.

The asset bubble that arose in 1980s was attributed to a combination of very high land values and very low interest rates. It led to a situation where cheap credit was easily available. The Japanese businesses and households started borrowing large sums of money to invest in domestic and foreign securities. The Japanese stock index (Nikkei) rose its all-time high on December 29, 1989. The Japanese government issued 100-year bonds to match the yields from housing, stocks, and bonds. Looking back, during the height of the bubble, the real estate sector was extremely over-valued. Tokyo's Ginza district was one of the Japans costliest areas in 1989, with some properties fetching over US\$1.5 million per square meter. After evaluating the situation, the Japanese Finance Ministry decided to curb the bubble by sharply raising the interest rates in late 1989. This sudden rise in interest rates led to the sudden decline of the stock market, finally ending the asset bubble. Japanese started facing the debt crisis; toxic assets started accumulating, which fueled the banking sector crisis. Massive bailouts were required to save the unsustainable banks; waves of consolidation and nationalization of banks took place. Many Japanese companies were burdened with massive debts, paralyzing their investment and growth abilities.

According to Paul Krugman the Lost Decades of Japan were due to liquidity trap, too much saving on the part of both Japanese consumers and firms led to the slowdown of the entire economy. According to him the land and stock market prices tripled during the prosperous 1980s. Mr. Krugman believes that Japanese have high personal savings rates, partly due to their demographics of an aging population, and culture. This enabled Japanese companies to borrow from traditional bank supported by the banking networks, as opposed to issuing commercial paper, or raising money by issuing stock or bonds. He

wrote: *"The cozy relationship of corporations to banks and the implicit guarantee of a taxpayer bailout of bank deposits created a significant moral hazard problem, leading to an atmosphere of crony capitalism and reduced lending standards. Japan's banks lent more, with less regard for quality of the borrower, than anyone else's. In doing so they helped inflate the bubble economy to grotesque proportions."*

During the late 1980s, the time when the asset bubble was rising, unusual phenomena were observed within the real estate sector:

- Those who had land became richer, and those who didn't, had little chance of buying, leading to the sense of inequality and social injustice in the society.
- Vacant lands were considered much more valuable due to their liquidity than the lands with buildings on them. That incentivized Yakuza (the Japanese mafia) to illegally demolish buildings, and force landowners to sell their lands.
- Mushrooming of unoccupied office buildings in urban areas accelerated.
- Excessive numbers of amusement parks, hotels, tourist attractions, and resorts were being developed. The assumption was that these facilities would be potential sources of large revenues.

Countercyclical Stimulus

After encountering the meltdown of their economy, in 1991 the Japanese government decided to stimulate it by enacting countercyclical fiscal policies, and by increasing social security payouts. During 1990s the Japanese fiscal spending became unrestrained to the level that it beat all other advanced industrialized countries. Prior to 1991, the government spending (outlays) in Japan accounted for just 31.6 percent of the nation's GDP, one of the lowest among members of the Organization for Economic Co-operation and Development (OECD) [Ronald D. Utt, December 2008]. Once the interest rates were raised and the economy started sliding downwards, Japanese government started spending on infrastructure projects in order to stimulate the economy. After maintaining a relatively high level of public investment for several years, Japan's highest spending

came in 1995 and 1996, peaking at over 43 trillion yen, or more than 8.9 percent of GDP, in first quarter of 1996. The year 1997 was the turning point of Japan's efforts to stimulate its economy through public spending. Japan began steadily curbing its spending since then. Public investment in Japan has since fallen to under 4 percent of GDP.

Spending on Infrastructure Projects

As a 2001 Heritage Foundation report noted, a substantial portion of the Japan's stimulus spending was focused on infrastructure. During 1992-2000, Japanese government implemented ten separate fiscal spending packages in which public infrastructure projects was a major component. The additional spending on the infrastructure component amounted to 30.4 trillion yen, (\$254 billion). The report also stated that Japan's government spent too much on roads and bridges, and not enough in the areas of education, social services, technology (research and development), which, other studies have proved deliver more long term benefits than infrastructural expenditure. *"It is not enough just to hire workers to dig holes and then fill them in again,"* said Toshihiro Ihori, an economics professor at the University of Tokyo. *"One lesson from Japan is that public works get the best results when they create something useful for the future."*

According to the Japanese Cabinet Office, Japan spent \$6.3 trillion on construction oriented public infrastructure investment between 1991 and September of 2009. The spending was highest in year 1995 and remained high until the early 2000s. After 2000s, the spending was reduced taking into account the growing concerns of the country's rising budget deficit and debt. During the high spending years, the regional economies had started depending on the government leaders in Tokyo for jobs. The government leaders in Tokyo were the members of Liberal Democratic Party; they used government spending as their tool to buy rural votes and converted their nation into a public-works-based welfare state. According to Fackler, most Japanese economists believe that their country *"spent more than enough money, but wasted too much of it on roads to nowhere and other unneeded projects"*.

In his survey of public works in the 1990s, Dr. Ihori of the University of Tokyo concluded that the spending on the infrastructural projects created almost no additional economic growth. He found that crowding out of private investment started taking place due to massive government spending. According to him, the only beneficiaries of the job creation were the construction industry workers concentrated in the rural areas. His study also concluded that too much of the spending went in overbuilding an already heavily developed nation. Critics of these projects also said that, spending decisions were made behind closed doors by politicians, construction industry personnel, and bureaucrats, often considering political and personal benefits over the country's economic development.

A cost benefit study conducted by a nonprofit policy research group, Japan Institute for Local Government in 1998, found that “every 1 trillion yen (\$11.2 billion), spent on social services like care for the elderly and monthly pension payments added 1.64 trillion yen in growth. Financing for schools and education delivered an even bigger boost of 1.74 trillion yen, the report found. But every 1 trillion yen spent on infrastructure projects in the 1990s increased Japan’s gross domestic product, a measure of its overall economic size, by only 1.37 trillion yen, mainly by creating jobs and other improvements like reducing travel times.” Based on the above study, an advanced economy such as Japan should have spent stimulus money on higher-paying (long term) human capital, and on knowledge-based professions such as health care, technology, and education.

“In hindsight, Japan should have built public works that address the problems it faces today, like aging, energy, and food sources,” said Takehiko Hobo, a professor emeritus of public finance at Shimane University in Matsue. “*This obsession with building roads is a holdover from an earlier era.*” The fruits of that obsession are apparent across Shimane, a rural prefecture about the size of Delaware where Hamada is located. Each town seems to have its own art museum, domed athletic center and government-built tourist attraction like the Nima Sand Museum, a giant hourglass in a glass pyramid. The prefecture, with 740,000 residents, even has three commercial airports able to handle jets, including the \$250 million Hagi-Iwami Airport, which sits eerily empty with just two flights per day.

In Hamada, residents say the city's most visible "hakomono," the Japanese equivalent of "white elephant," was its own bridge to nowhere, the \$70 million Marine Bridge, whose 1,006-foot span sat almost completely devoid of traffic. Built in 1999, the bridge links the city to a small, sparsely populated island already connected by a shorter bridge. "*The bridge? It's a dud,*" said Masahiro Shimada, 70, a retired city official who was fishing near the port. "*Maybe we could use it for bungee jumping,*" he joked.

Koichi Matsuoka, a retired professor of policy at the University of Shimane in Hamada, said, "*useless projects like the Marine Bridge were the reason that years of huge spending had brought few long-term benefits here*". While Shimane has had the highest per capita spending on public works in Japan for the last 18 years, thanks to powerful local politicians like the deceased former Prime Minister Noboru Takeshita. Its per capita annual income of \$26,000 ranked it 40th among Japan's 47 prefectures, he said. According to him, the spending had left Shimane \$11 billion in debt, twice the size of the prefectural government's annual budget. According to Peter Dyloco, the road builders laid down more than 1.1 million kilometers of asphalt across the country, more than four times the length of Great Britain's expressways combined. "*It is, and the cost of upholding Japan's public infrastructure is extravagant beyond belief. Japan spends an average of five percent (or \$236 billion USD) of its national GDP funding maintenance projects from Kyushu to Hokkaido. Compare that figure to that of the United States, which dedicates little more than two percent of its national GDP towards the same thing, or to Great Britain's measly 2.5 percent. To fund for the difference, road tolls and vehicle taxes – the most expensive of any developed country, continue to drain exorbitant amounts of money from the average taxpayer.*" [Peter Dyloco April 2011]

Japan has ninety-eight airports, and ninety percent of them are not profitable. Redundant highways connect the same cities with no significant differences in the travel time and distances. According to Peter Dyloco, at the same time most of the important projects related to the improvement in country's educational system, and social services remain ignored. The overwhelming majority of the infrastructural spending is serving the

interests of the individuals involved in construction project industry itself. Most of this spending is attributed to the pork barrel spending.

Japan “*didn’t do a good job of timing the expenditures,*” said Michael Smitka, a professor of economics at Washington and Lee University who has focused on Japan for nearly 30 years. He claims that Japan’s haphazard, poorly coordinated, and often ill-timed implementation of infrastructure spending, prevented it from having more impact.

Liberal Democratic Party that was in power in Japan throughout the decade had a strong rural base, resulting in political pressure to ensuring sparsely populated prefectures got their piece of the pie. Spending was not necessarily directed to the regions where economic needs were greatest; in fact, the procedure was to spread funds evenly across all prefectures, having no mechanism to target funds to projects in high-density urban areas. Rural districts gained disproportionate funding, often to be spent on projects that were little needed (small-scale Japanese Bridges to Nowhere). The projects themselves were often ill conceived, designed with more of an eye on their political costs and benefits than on their societal and economic desirability. The result was expenditures that had almost no social value beyond the work created by the projects they funded.

The Japan's government continued to inject money into subsidies for local governments and municipalities, encouraging them to take on additional debt, which they simply could not repay. The cost benefit analyses were based on hopelessly optimistic assumptions and predictions. Tremendous amounts of tax (yen) were earmarked for maintenance and construction initiatives. According to Timon Singh, “*The Ibraki airport, whilst the Japan Airlines are struggling with bankruptcy and increases in losses, comes the news that the country has opened its 98th airport... however it only offers one flight a day*”. “The Ibaraki airport cost \$220 million to build and due to its 'limited' services, it has been blasted as a massive waste of public expenditure, especially as it's 50 miles north of Tokyo. It was conceived as a hub for budget carriers but cutbacks worldwide meant that the airport was practically deserted on its first day” [Timon Singh].

The Reform and Further Decline

The government of Prime Minister Junichiro Koizumi (2001-2006) started to implement reform measures, such as curbing highway construction expenditure, privatizing the Japanese postal services, and reforming the banking system. But in 2001, global economy suffered more shocks caused by the terrorist attacks on the United States, leading to the global slowdown and the Dot com bubble burst, that led to further opposition to the Prime Minister's fiscal conservatism.

At present, Japan's public debt is more than 200 percent of its annual gross domestic product, largest of any nation in the world. In 2009, the gross public debt exceeded 170% of GDP, making Japan the most indebted nation among major world economies. Large budget deficits and government debt since the 2009 global recession, followed by earthquake and tsunami in March of 2011 caused even further damage to an already sluggish economy. In August of 2011, Moody's lowered Japan's long-term sovereign debt rating one notch from Aa3 to Aa2 in accordance with the size of the country's deficit and debt level.

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