Chapter 13

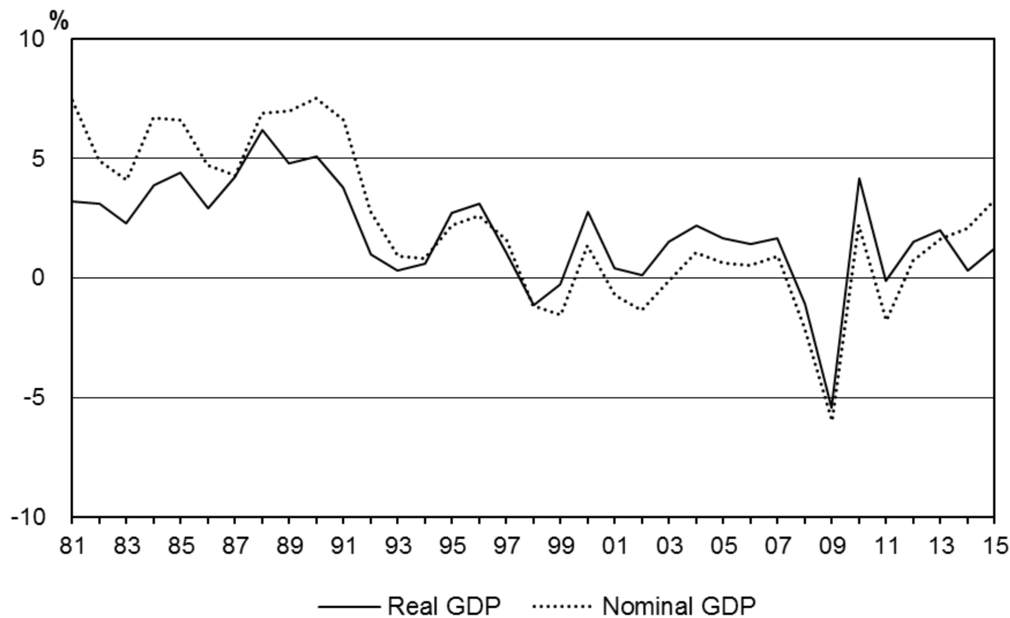
The Asset Bubble and Prolonged Recession

1. Post-bubble stagnation and the debate over reforms

Japan experienced an asset bubble in the late 1980s. After the bubble collapsed in 1990-91, the Japanese economy was plunged into a long period of deflation and recession. Growth became near zero and sometimes even negative. For the first time in the postwar period, general price levels declined persistently. Economic statistics remained gloomy and, more importantly, consumers and producers became pessimistic. Some said that Japan was still a very high income country. Others said that sources of the next growth were being prepared under the disguise of recession, and pointed to some companies that were doing very well. But overall, it can hardly be denied that Japan's economic performance in the 1990s and the early years of the twenty-first century was less than hoped for.

The 1990s became Japan's Lost Decade. Naturally, the main argument among Japanese economists was why this recession persisted and what should be done to end it. More specifically, the key question was whether or not bold structural reforms and deregulation measures, which were supposed to revive economic dynamism, should be undertaken at a time when the overall economy was very weak. Some argued that painful reforms were necessary precisely when we faced a recession. Others argued that structural reforms should not be carried out under poor economic conditions. Instead, they argued that fiscal and monetary stimuli should be mobilized for lifting the economy before such reforms were attempted. The debate continued well into the twenty-first century with variations and added aspects. The policy actually adopted was that of fiscal activism and aggressive monetary injection into the macroeconomy with forced zero or negative interest rates, interlaced with occasional and modest postures for fiscal consolidation.

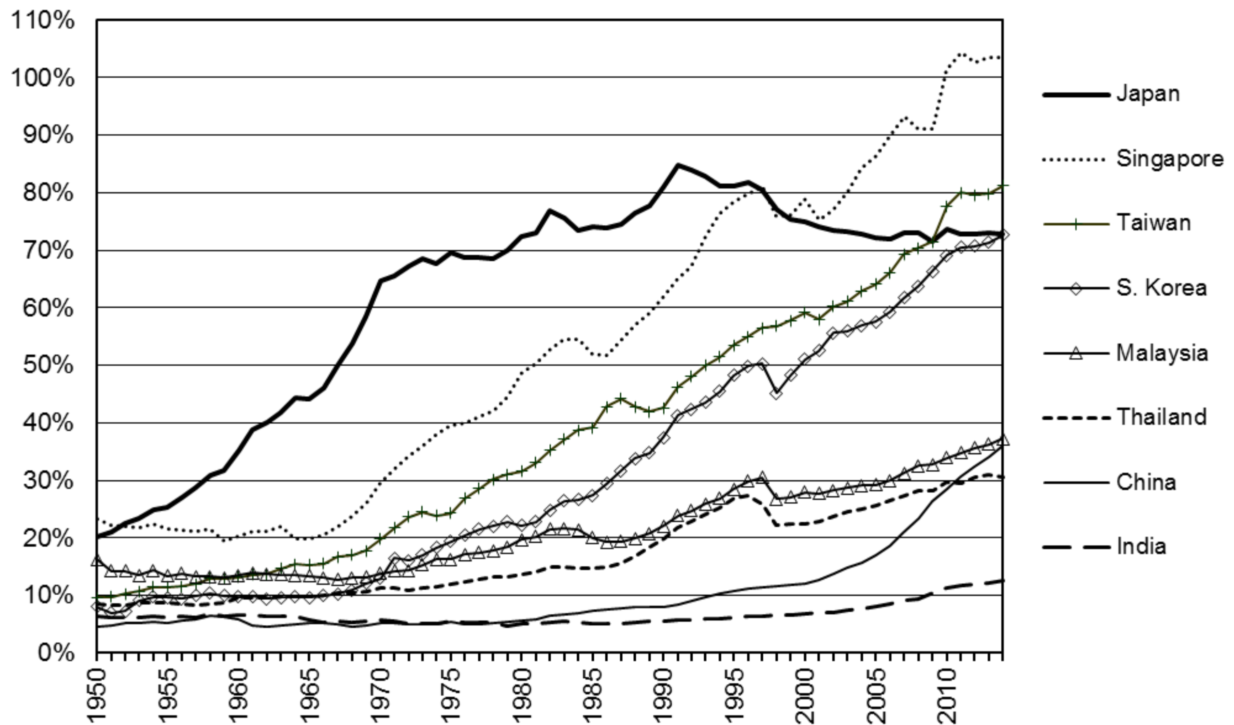
Figure 13-1. GDP Growth



Source: Cabinet Office.

The business situation picked up in some years thanks to strong demand in the United States and/or China and a transitory yen depreciation, but growth impetus was never sufficient to put the Japanese economy on a robust development path. In other years there were shocks originating abroad—the Asian financial crisis in 1997-98, the IT bubble crash in 2001, the global financial crisis in 2007-08, which was particularly severe and pulled Japanese growth well into the negative range, and the Euro economic and political crises starting from 2011. Japan also faced internal problems including the banking crisis culminating in 1997-98, the Kobe Earthquake in 1995, the Great East Japan Earthquake and the Fukushima nuclear accident in 2011, and intermittent political instability. While most other Asian economies, especially China, were growing strongly, Japan's real income per capita steadily declined relative to its neighbors, and so did its economic and political clout in the region. Japan's Lost Decade turned into the Lost Quarter Century.

Figure 13-2. Real Income per Head Relative to the United States



Sources: Angus Maddison, *The World Economy: Historical Statistics*, OECD Development Centre (2003); updated to 2014 using International Monetary Fund, *World Outlook Database*.

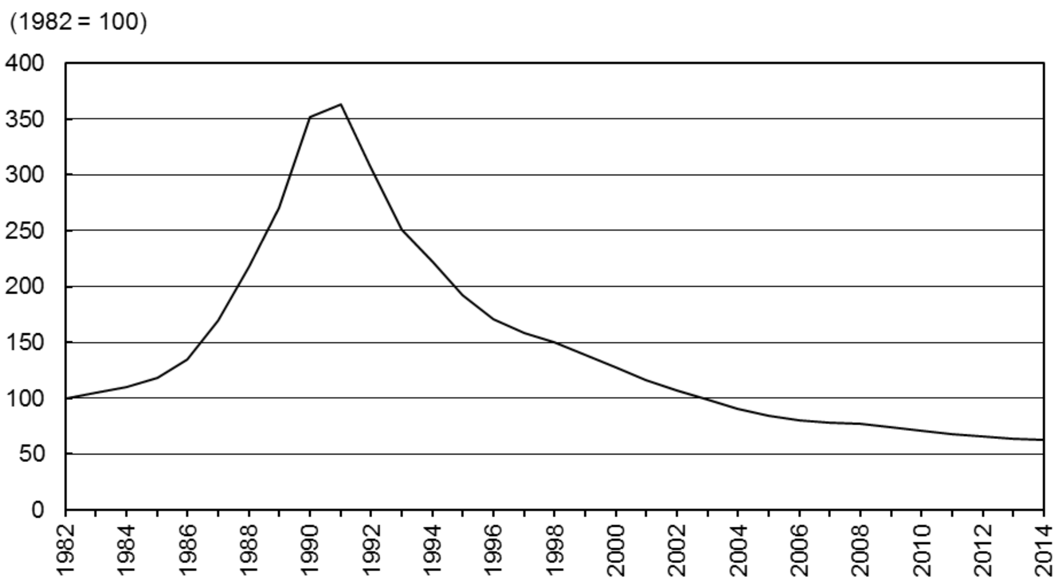
2. The occurrence of the asset bubble

Japanese stock prices began to rise in the early 1980s and peaked in 1990 at more than five times the 1980 level. Then, it started a long period of decline with medium-term fluctuations. Japanese land prices also rose throughout the 1980s until they more than doubled. The turning point for land prices came a year later, in 1991. Since then, the land price index has continued to decline. Urban land prices rose more and fell harder in comparison with rural land prices. There are two explanations of why this asset bubble emerged.

Figure 13-3. Nikkei 225 Stock Index Average

Source: Bank of Japan Time-series Data Search.

Figure 13-4. Urban Land Price



Source: Japan Real Estate Institute.

The first was a structural one associated with bank deregulation. Previously, Japanese banks were tightly regulated by the Ministry of Finance. There was little incentive to innovate, but as long as banks followed official instructions, they were assured of adequate profit margins and protection against bankruptcy. This rigid regime was removed in the early 1980s in an effort to liberalize the Japanese financial sector under the pressure of globalization and a rising stock of government bonds. As competition began, extra bank profits associated with protection vanished. At the same time, large corporate customers moved away from domestic bank loans to other funding such as retained profits, corporate bond issuance and access to international financial

markets. As Japanese banks lost lucrative corporate customers, they rushed to find new—untested and more risky—borrowers and projects such as small and medium business loans and property investments, especially urban office buildings and rural resort development. But they lacked the capacity to properly assess and monitor these borrowers and projects. When the economy was booming in the late 1980s, they over-lent. Careless business strategies and potential problems were concealed. When the bubble ended, loans that banks had made became a huge mountain of bad debt (Yoshitomi, 1998).

The second cause was monetary; easy money in the late 1980s generated and sustained the asset bubble. The yen appreciated sharply in 1985, which triggered the Bank of Japan to lower short-term interest rates and increase money supply. This was the Bank of Japan's traditional policy response to a high yen which aimed at stimulating export and investment to offset the negative impact of yen appreciation. Many later blamed then Bank of Japan Governor Sumita Satoshi, who implemented this policy, for easing too much and for too long. But because domestic price inflation was close to zero at that time, the Bank of Japan could not find a good reason to tighten money and end the asset boom everyone was enjoying. There was a signaling problem—when asset prices rise but goods prices remain stable, is monetary policy too generous or not? The data shows that the annual growth of broad money (M2+CD) accelerated to more than 10 percent during 1987-89. In retrospect, this was too high for an economy growing at about 4 percent. Succeeding Bank of Japan Governor Mieno Yasushi, who assumed the office in December 1989, deliberately tightened money and raised interest rates to end the bubble, and it did collapse quickly. Some criticized Mieno for his brutality, but can an asset bubble go on forever? It had to end some time, and usually the sooner the better.

These two explanations are not mutually exclusive. Bank deregulation explains why reckless projects began to be financed and monetary expansion explains why the bubble continued for so long. These were structural and macroeconomic reasons which complemented each other to produce the rise and fall of the asset bubble.

During the rising phase of the bubble in the late 1980s, many queer phenomena were observed. Those who owned land became very rich while those without land faced little chance of buying their home, which increased the sense of inequality and social injustice. Enriched people bought luxury goods and consumed lavishly, travelling all over the world to snap up landmark towers and art objects in a situation similar to the narikin boom during WW1 (chapter 7). Students chartered a luxury cruiser to organize a graduation party in the Bay of Tokyo. Discotheques became popular with the youth where girls displaying large fans danced on the stage. Since vacant land was more valuable than built-up land, the *yakuza* (Japanese mafia) was hired to illegally demolish buildings and forced owners to sell the land. Sometimes the yakuza drove a truck into a house to destroy it.

Too many office towers were built in urban areas, which remained empty or unfinished for many years to follow. A large number of amusement parks and resort hotels were also developed.

Among them, the only hugely successful one turned out to be Tokyo Disneyland while others subsequently got into financial trouble. Some were transferred to new owners for restructuring, including Huis ten Bosch (Dutch theme park in Nagasaki), Phoenix Seagaia Resort (seaside complex in Miyazaki), and Alpha Resort Tomamu (winter sports resort in Hokkaido). Thanks to the building boom, a large number of male construction workers from the Middle East, especially Iran, came to Japan. Some of them had work permits but others did not. Every weekend they gathered in Ueno Park in Tokyo to enjoy themselves and exchange information.

But after the bursting of the asset bubble, these phenomena all disappeared.

3. The Lost Decade

GDP statistics and other business indicators such as industrial production, machine order, housing starts and wage and unemployment reveal that business conditions were not uniformly poor during the first decade following the end of the bubble. The Japanese economy declined three times, in 1992-93 immediately after the bubble collapse, in 1997-98 following the consumption tax hike[1] and the banking crisis, and in 2001 amid the US and global IT recession. However, economic performance in intervening periods was not so bad. There were times when the Japanese economy appeared to improve. In 1996, Japan's real growth registered 3.5 percent which was highest among the G7 countries. But each time, the recovery was short-lived. Not surprisingly, small businesses faced greater difficulties than large enterprises in sales, corporate finance, and other aspects. Banks no longer lent to small and medium enterprises.

The big question is, why did the Japanese economy remain so weak for so long after the bubble burst? Economists debated but no consensus view emerged. One explanation was purely cyclical. Since the bubble created large overcapacity, it would take time to reduce the capital stock and inventory to normal levels. But a decade seems too long for such stock adjustment. Another explanation was related to non-performing loans held by financial institutions. Because banks failed to get rid of bad debt, and because the government did not introduce proper measures, financial intermediation was impaired which hurt the real economy. This vicious circle continued until a bold action to clean up the banks' balance sheets was taken toward the end of the decade (see below).

Another popular explanation was that Japan's economic system had become obsolete. Japan's long-term relational systems, such as lifetime employment, seniority wage, keiretsu groups, sub-contracting, administrative guidance, and so on, might have worked well during the 1950s and 60s, but they became ineffective in the age of rapid change and globalization. Some argued that Japan must face a third major transformation (the first was Meiji revolution and the second was

[1] In April 1997, the Hashimoto Cabinet, backed by the Ministry of Finance's desire to restore fiscal soundness, raised the general consumption tax from 3 to 5 percent. The economy weakened immediately and the tax hike was blamed. However, it is strange that such a small tax increase had such a huge economic impact.

post-WW2 reforms). But others cautioned that Japan should not adopt the American system uncritically because many Japanese systems were still useful—see the box at the end of Chapter 9. Yet another explanation pointed to the long-term changes in Japanese society. The nation had rapidly aging population and snowballing government debt. People became uncertain about future regarding income and jobs, rising tax burden and the sustainability of medical care and pension schemes. This pessimism slowed down consumer spending and business investment.

Externally, the emergence of China as the factory of the world and other newly industrializing economies, and the "hollowing-out" of Japanese manufacturing (the exodus of factories and jobs to other countries), were cited as a great threat.

It is highly probable that Japan's long stagnation was the combined result of all these problems in mutual interaction even though the exact weight of each is difficult to determine. But if one ultimate cause behind these problems is to be named, that must be the lack of political will and leadership. Japan did not have a prominent leader who could identify key national issues, explain the situation to the people in honest and persuasive language, design and implement long-term solutions, and assume full responsibility for this. Japan's problems listed above are not particularly colossal or intractable in comparison with problems faced by other countries. The uncertainty and anxiety permeating in Japanese society must be explained by the low quality of leadership rather than the size of the problems. Japanese people just did not believe that their leaders had the courage and capacity to cope with these "normal" problems. This was the situation prevailing in the first Lost Decade. Unfortunately, the political and economic landscape did not improve significantly in the following decades.

4. Financial crisis and monetary policy

In the post-bubble period, Japan's monetary authorities faced two challenges. The first was coping with non-performing loans, which took as long as a decade to clean up. The second was reviving the macroeconomy, which remains unfulfilled even to this date.

In the early 1990s after the asset bubble collapsed, Japanese financial institutions which previously lent recklessly to small and medium enterprises and property development projects got into trouble. The declining land and stock prices seriously hurt the balance sheets of commercial banks and *jusen* (nonbank institutions specializing in real estate loans). Japanese financial institutions often required land as loan collateral and engaged in mutual stock holding, but the values of both assets plummeted. Bad debt further rose as the recession continued and corporate bankruptcies increased. As non-performing loans accumulated, many Japanese banks faced difficulty in observing the Bank for International Settlement (BIS) capital adequacy requirement, which said that a bank's capital must be at least 8 percent of its risk assets, properly weighted, if it was to engage in international business. If this ratio fell below 4 percent, the bank

was not allowed to conduct even domestic business and had to close.

In 1995 and 1996, the mounting bad debt at jusen became a political problem. But this was only the beginning. Toward the end of 1997, the fear of commercial bank defaults was widespread. When Yamaichi Securities and Hokkaido Takushoku Bank went bankrupt, the fear turned into reality. In the following year, the Long-Term Credit Bank and the Securities and Credit Bank also fell. For survival, remaining banks scrambled to improve their BIS ratios by reducing risky assets. This was done by lending less, especially to small and medium enterprises. This led to a credit crunch in the real economy, causing more bankruptcies and further worsening the quality of bank assets. This vicious circle continued from late 1997 to early 1998. Japanese banks were considered untrustworthy, and the "Japan premium," an additional charge to Japanese banks when they borrow internationally, surged. People wondered which bank would fail next. Worried savers shifted their deposits from seemingly risky banks to bigger and safer ones and postal savings.

In response to the 1997-98 banking crisis, the government created the Financial Supervisory Agency in October 1998 and the Financial Restructuring Commission in December 1998. They were merged to become the Financial Services Agency in 2000. The government also prepared "public money" up to 60 trillion yen (12 percent of GDP) to deal with the bad debt problem, recapitalize banks and manage the closure of weak banks. As a result of financial deregulation and crisis, Japanese banks also began to merge. In the 1970s and 80s under the old regulated regime, the number of commercial banks was very stable at 86, among which 20 were relatively large. They began an active merging process in 1999 which ultimately produced three Mega Banks—Mitsubishi UFJ, Mizuho and Sumitomo Mitsui—by 2006.

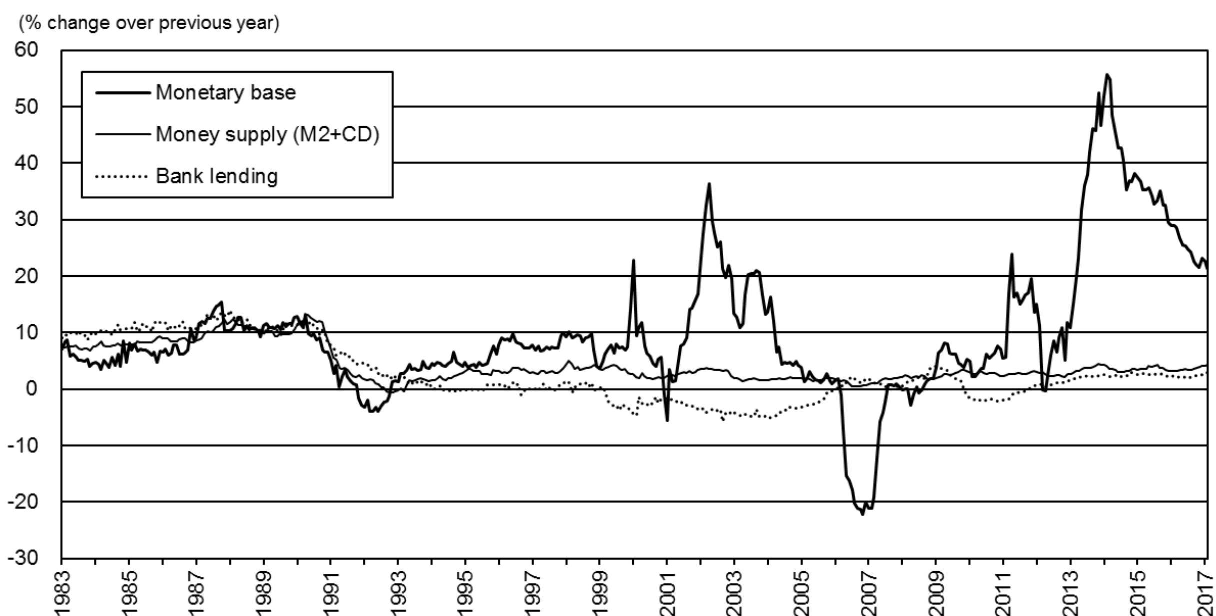
The Bank of Japan responded to the 1997-98 banking crisis by providing ample liquidity. Subsequently, it adopted a "zero interest rate policy" in April 1999 in an effort to revive the overall economy. This meat that the short-term interbank rate (the call rate), which the Bank of Japan directly controlled, was lowered to zero except for a very small technical margin. The Bank of Japan tried to end this abnormal policy in August 2000, but as the economy further worsened it was forced to return to zero interest. The official discount rate was also reduced to a very low level, from 6 percent in 1990 to 1.75 percent in 1993, and to 0.10 percent in 2001. The financial panic subsided in early 1998, but general recession persisted into the 2000s.

Even with the zero interest rate policy in place, pressure on the monetary authorities to do more to stimulate the economy did not let up. Some argued for a more drastic increase of money supply by any means. To do so, the Bank of Japan was advised to purchase more risky assets including bank and corporate bonds, foreign bonds and mortgage bonds. Traditionally, it bought and sold only government bonds for safety reasons. Another group of economists proposed inflation targeting. According to them, the Bank of Japan should announce a positive inflation rate for the next two to three years and be responsible for it. This was considered necessary to change people's expectations about future inflation. Paul Krugman (Princeton University), Alan

Meltzer (Carnegie-Mellon University), Ito Takatoshi (Tokyo University), and Itoh Motoshige (Tokyo University) supported this idea. But others, including Bank of Japan economists Okina Kunio and Ueda Kazuo, were skeptical. They argued that, even if the Bank of Japan tried, there would be little impact on expectations because the monetary transmission mechanism was broken. Worse, if people's expectations suddenly shifted for whatever reason, after too much liquidity was injected, the resulting inflation would become uncontrollable.

Anomaly in Japan's monetary transmission mechanism deserves special attention. Normally, the central bank controls monetary base (deposits by commercial banks at the central bank, plus cash) which influences money supply and commercial bank lending, the two important intermediate targets for macroeconomic management. This in turn impacts on production and investment. This is the monetary transmission mechanism by which a central bank stimulates or restrains overall economic activity. However, relationship between monetary base on the one hand and money supply and commercial bank lending on the other became unstable in post-bubble Japan. As Figure 13-5 shows, these variables moved more or less in tandem in the 1980s. But a disconnect emerged after the bubble collapse in 1990-91. Monetary base was pushed up by the Bank of Japan gradually but in increasingly large doses. But even a massive injection of monetary base did not lead to any visible increase in money supply, and commercial bank lending remained flat or even declined. When interests were zero or negative, there was no penalty (foregone interests) for holding dead cash so banks did just that. Excess deposits by commercial banks at the central bank ballooned without turning into business loans or investment. Japan's monetary transmission mechanism is broken. Unless this is fixed, pumping more money into the financial system will add little impetus for growth.

Figure 13-5. Monetary Base, Money and Bank Lending

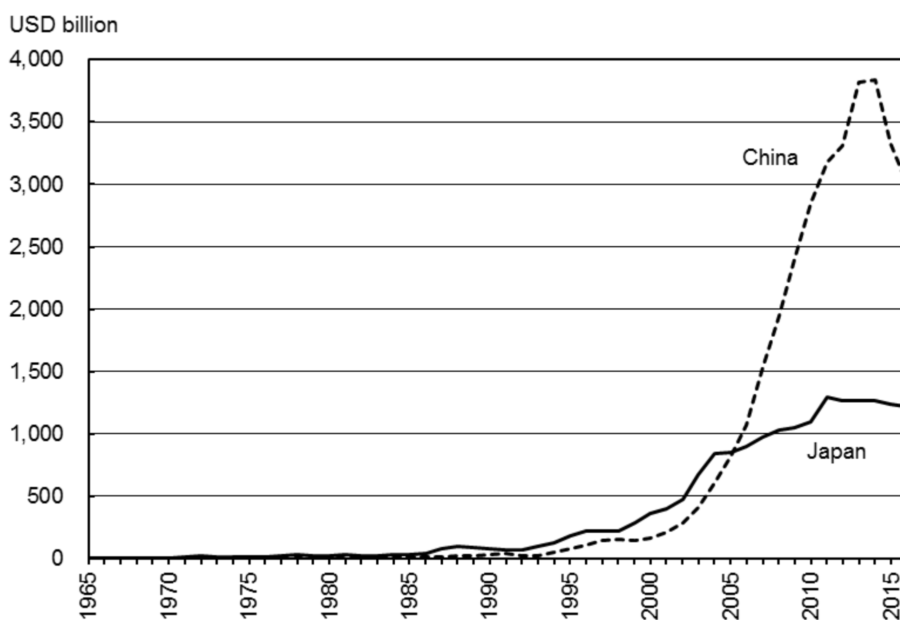


Source: Bank of Japan Time-series Data Search.

Another issue related to monetary policy was a call for yen depreciation. Some insisted that aggressive monetary expansion coupled with an official statement to welcome a weak yen would depreciate the yen, improving Japan's international competitiveness and stimulating export and domestic business. The government and the Bank of Japan sometimes appeared to endorse this strategy, and the yen actually depreciated moderately when such policy intention was announced. But currency depreciation is a controversial beggar-thy-neighbor policy in which Japan gains at the cost of other countries. If the United States, China or any other large trading partner opposes the yen's weakening, this policy will have to end. Moreover, exchange rate adjustment is unable to solve the long-term structural problem of any country, and often diverts attention from the real cause of economic weaknesses (chapter 12).

For long, the Bank of Japan intermittently intervened in the foreign exchange market to curb yen appreciation when it was deemed excessive. Since 2011, however, it has refrained from pushing up the dollar to keep the yen cheap in the currency market. This policy shift is reflected in Japan's international reserves which peaked at $1.296 trillion in 2011 and fell slowly since then. China dramatically overtook Japan as the largest collector of international reserves in the world in 2006 and continued to accumulate up to $3.843 trillion by 2014. But even China stopped purchasing dollars and began to sell them in the foreign exchange market in order to counter the recent declining pressure on RMB.

Figure 13-6. International Reserves

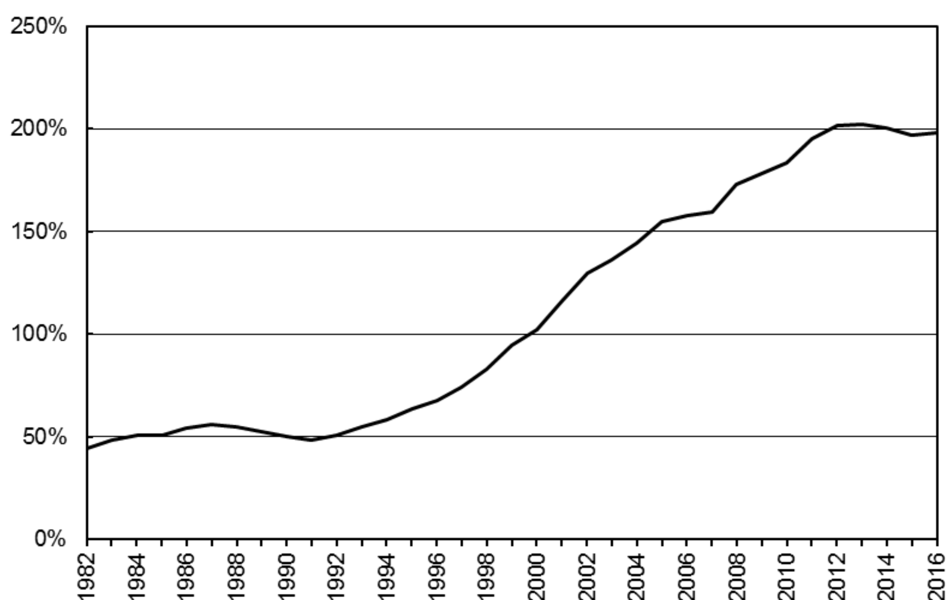


Sources: Bank of Japan Time-series Data Search, and State Administration of Foreign Exchange, China.

5. Unstoppable fiscal activism

Fiscal policy has been expansionary since the 1990s, although some say that it has not been expansionary enough relative to what they think is adequate. At the end of fiscal year 2015 (March 2016), outstanding government debt stood at 1,066 trillion yen amounting to twice GDP. This is the highest ratio among major industrial countries[2] although it stabilized, temporarily, in recent years thanks to relatively strong tax receipts. Budget deficit is bound to grow in the long run even with effort in spending cuts because fiscal expenditure is dominated by two mandatory and constantly increasing components, namely, servicing of past debts and social security payments, which respectively occupied 24.4 percent and 33.1 percent of total expenditure in fiscal year 2016. It is uncertain whether this public debt explosion can be slow down and reversed in the future. Moreover, the above figure does not include short-term debt or contingency liabilities (amounts that are unknown at present but must be paid in the future for rescuing the bankrupted social security system, cleaning up the nuclear disaster, coping with natural calamities, etc.) International rating companies have downgraded Japanese government bonds in recent years.

Figure 13-7. Government Debt as Percent of GDP



Sources: Ministry of Finance, and Cabinet Office.

The government is often torn between the need for fiscal consolidation and the wish for more

[2] In 2015, the ratio of general government (central and local governments) gross debt to GDP of Japan was 248 percent, which was highest in the world (IMF World Economic Outlook Database, October 2016). The other countries whose public debt stock was greater than GDP were Greece (177 percent), Italy (133 percent), Portugal (129 percent), Cyprus (109 percent), Belgium (106 percent), United States (104 percent) and Singapore (103 percent).

macroeconomic stimuli. But most of the time, fiscal policy tended toward expansion because weak business situation at hand is politically more critical (for the next election) than restoring a sound budget in the distant future. There has always been a strong political pressure for additional fiscal stimuli to avoid a "deflationary spiral" (price deflation and output recession enforcing each other). Many contended that no reform was possible unless and until the economy improved. Others comforted that Japanese government bonds were debt owed mostly to Japanese people, which was less worrisome than debt owed to foreigners.

But effectiveness of fiscal policy under such circumstances is an open question. Opponents of fiscal activism countered that Japan had already tried fiscal stimuli many times since the early 1990s, but the economy had failed to recover strongly. They argued that old-fashioned fiscal spending driven by local politics and lobbyists, which built expensive but underused highways, bridges, airports and Shinkansen (fast trains), would only benefit construction companies while national debt snowballed. Did Japan really need three giant bridges to span the Inland Sea? Did Kansai Region need three airports next to each other? Further fiscal stimuli, which would add to the already huge government debt, might actually lower growth due to greater pessimism over fiscal vulnerability and unsoundness. The current political system in which votes are secured by channeling fiscal spending to rural supporters should be ended, it is said.

There were attempts to cope with the fiscal time bomb. The Koizumi government (2001-06, Liberal Democratic Party) set limits on infrastructure and social welfare spending but succeeded in slowing down the speed of debt accumulation only for one year, in 2003. From 2009 to 2012, three consecutive governments of the Democratic Party of Japan cut "unnecessary" public projects randomly and arbitrarily but did not touch the social welfare spending which was the largest and most rigid part of public expenditure. The second and third governments of Abe Shinzo (2012-, Liberal Democratic Party) returned to monetary and fiscal activism (see below).

In 2012, the parliament passed a plan to raise the general consumption tax in steps but it was only partially implemented. The tax was raised from 5 to 8 percent in 2014 but the subsequent increase from 8 to 10 percent was put on hold (until 2019) due to weak business conditions. Welfare "reforms" are underway to increase people's payments and decrease their receipts, but it is questionable whether this is really a solution or mere acceptance of the worsening social welfare balance sheets. In 2014-15, business profits and corporate income tax receipt both rose thanks to the "success" of Abenomics, which slightly reduced the need to issue new government bonds. But this improvement may be temporary.

It is unclear what Japan's gigantic fiscal debt will bring in the future. The debate between fiscal activists and sound budget campaigners goes on. Innovative ideas, such as issuance of unredeemable public bonds or the Fiscal Theory of Price Level (don't worry about budget deficit, inflation will solve it later), are occasionally floated but their relevance to reality is in question. Joseph Dodge, who imposed a super-balanced budget on occupied Japan in 1949, or traditional IMF conditionality, would surely require Japan to tighten its budgetary belt despite short-term

pain and protests. But Japan is not under US occupation or IMF financial rescue. Alternatively, hyperinflation or unilateral debt cancellation would instantly solve the problem, even at great costs to certain people, but such sweeping measures are difficult to propose, let alone adopt, in peace time. Meanwhile, domestic politics does not seem to generate any policy option to pay short-term cost first to achieve long-term gain later. Perhaps that is the crux of the problem.

6. Earthquakes

Japan, sitting on where four tectonic plates meet and shove each other on the earth's crust, is continuously hit by large and small earthquakes. In the last few decades two large quakes caused particularly serious human and physical damage.

On January 17, 1995, an active fault under the port city of Kobe moved to destroy urban dwellings and structures resulting in 6,437 fatalities, which were mostly due to collapsing houses. The physical damage of this earthquake was estimated at 9.9 trillion yen or 2.0 percent of GDP, and the recovery budget amounted to 3 trillion yen or 0.6 percent of GDP. As the damage was too big to be coped with by official hands alone, popular movement emerged to help natural disaster victims through NGOs and volunteering.

On March 11, 2011, a much greater, deeper and widely impacting earthquake occurred off the eastern coast of Japan, generating tsunami and killing 18,446 people due mainly to drowning. The estimated stock damage of this earthquake was 16.9 trillion yen or 3.6 percent of GDP, and the recovery budget for the first five years was 19 to 23 trillion yen or 4.0-4.9 percent of GDP. This did not include the costs related to the Fukushima nuclear accident. The handling of this earthquake by the Kan government (Democratic Party of Japan), including formulation of the reconstruction plan, response to the radiation problem, power shortage and future energy policy, was severely criticized as inept and haphazard.

The human and physical damage of these earthquakes was immense. In terms of economic growth, however, the impact of an earthquake is usually hard to detect from annual statistics. This is because the negative effect of lost production capacity is offset by the positive effect of increased private and public investment for recovery and reconstruction. Gross National Happiness certainly fell, but Gross Domestic Product did not show any visible sign of decline. In case of the Great East Japan Earthquake, production fell temporarily and slightly in 2011 due to supply chain disruption and depressed national psychology, but recovered soon as vigorous reconstruction investments started. This even caused serious shortage of construction workers and materials. Global recession, yen appreciation and slowdown of Chinese or US economies will have much greater impacts on Japanese growth than natural catastrophes.

7. Aging, labor shortage and widening gaps

Japanese society is rapidly aging because old people live longer and young people are not eager to marry or have babies. Such trends are also visible in other countries, but Japan is the global leader in *koreika* (aging) and *shoshika* (producing fewer children). Japanese population peaked around 2008 at 127 million, then began to decline gradually. Depopulation is expected to continue well into the future. The share of working-age population (aged 16 to 64) started to decline much earlier, peaking at 70 percent around 1995, then falling to about 60 percent at present. This means fewer workers must support more retired people through higher tax burden and social security contributions. Shrinking and aging population also means lackluster domestic demand, reduced saving, low growth, and skyrocketing medical and pension bills. Japanese society, once based on communal spirit and intra-family care for the young and the old, no longer functions that way.

A related problem is *kasoka*, or accelerated decline and aging of population in rural areas to the extent that basic transport, medical and commercial services are no longer rendered. The problem of disappearing communities permeates in virtually all cities, towns and villages in rural Japan. This is caused by migration of young people to large cities for education and job opportunities, in addition to gradual passing away of remaining senior citizens. Revitalizing rural communities has become one of the top priorities of any Japanese administration.

Labor shortage has become apparent in recent years. The unemployment rate has steadily fallen from 5.1 percent in 2009 to 3.1 percent in 2016. Many businesses, especially small ones, find it difficult to recruit enough workers. Labor shortage is widespread in all sectors, and especially acute in such service industries as construction, transportation, food catering, elderly care and childcare. Scarcity of construction workers is aggravated by strong reconstruction demand in the aftermath of the Great East Japan Earthquake in 2011 and construction toward the Tokyo Olympics in 2020. Japan has traditionally accepted only a small number of foreign workers except those with highly professional skills or Japanese ethnic origin. This was largely because of the fear that a rapid increase in foreign workers may lead to social friction and problems such as crime and failure to integrate with Japanese society. However, the immigration policy now has to be reconsidered because labor shortage is a structural problem that is not likely to go away soon, and Japan must therefore rely heavily on foreign workers in the future.

Another serious problem is emerging social gaps. Japan in the 1960s attained high growth and income equalization simultaneously until most people felt that they belonged to the middle class (Chapter 11). After the bursting of the bubble, this happy memory was replaced by a sad combination of little growth and perceived inequality. Surveys conducted every three years by the Ministry of Health, Labor and Welfare show that income before tax and subsidies is rapidly becoming unequal, although there is no evidence of widening income gaps after income redistribution through tax and social welfare systems is taken into account. For income after redistribution, the Gini coefficient, which ranges from zero (perfect inequality) to one (perfect

equality), declined slightly from 0.3812 in 2002 to 0.3759 in 2014. The Ministry interprets this as evidence of effective redistribution policies[3].

Despite this, poverty is on the rise even after income redistribution. Japan's poverty ratio (relative definition counting the number of people below 50 percent of median income) increased during the last three decades from 12.0 percent in 1984 to 16.1 percent in 2014, which is second highest among advanced countries after the United States. Popular perception is that Japan is rapidly becoming an unequal society. In recent surveys, about 70 to 80 percent of respondents concur with this assessment[4]. In their view, this fact is most visible in wage gaps, followed by distinction between regular and non-regular workers (next paragraph), differentiated job opportunities, increase in low-income families and social service gaps between urban and rural areas. In Japan, inequality is associated mainly with increasing poverty rather than the existence of a very few extremely rich people (Tachibanaki, 2016).

Inequality in work places is most apparent in unequal treatment between regular workers who enjoy permanent status and non-regular workers such as part-timers and workers with short-term contracts. The ratio of non-regular workers has risen rapidly from about 20 percent in 1990 to 40 percent in 2014. The prolonged recession increased management's desire to cut labor cost and have an option to reduce workforce at times of slow business, as well as workers' reluctant acceptance of such inferior positions. Even if job description is the same, non-regular workers receive less wage to the tune of only 63 percent of regular workers (Ministry of Health, Labor and Welfare survey, 2014), little or no benefits and promotion prospects, and job insecurity. Female workers and youths account for the bulk of non-regular workforce, who tend to be trapped in the second-rate status with little prospect of moving up to regular positions. This generates long-term problems such as inability to marry for financial reasons, less production of children, low lifetime saving, continued poverty into old age and the next generation, and extreme hardship for single, divorced or widowed mothers. Even seemingly protected regular workers are forced to work hard to keep their position under strong cost-cutting pressure. Unpaid overwork is a common practice, often leading to job-caused illness and suicide.

In response, the Japanese government is promoting equality between regular and non-regular workers, urging wage increases and less working hours to company management, helping female labor to take up more jobs and high positions and, through all these, achieve better work-life balance for Japanese workers.

8. Abenomics

[3] The Ministry of Health, Labor and Welfare's data show that, before redistribution, the Gini coefficient rose significantly from 0.4983 (2002) to 0.5263 (2005), 0.5318 (2008), 0.5536 (2011) and 0.5704 (2014). But after redistribution, it was quite stable at 0.3812 (2002), 0.3873 (2005), 0.3758 (2008), 0.3791 (2011) and 0.3759 (2014).

[4] In the survey conducted by the Yomiuri Newspaper in March 2007, for example, 81 percent felt that gaps were widening while 3 percent did not think so. Don't Knows and no response accounted for the remaining 16 percent.

After the relatively strong government of Koizumi Junichiro (2001-06), a series of weak and short-lived governments ensued, three by the long-ruling Liberal Democratic Party (LDP—Abe, Fukuda and Aso) and three by the Democratic Party of Japan (DPJ—Hatoyama, Kan and Noda). Japan had six prime ministers in just as many years. In 2009, people voted for untested DPJ to replace unimpressive LDP leaders by fresher faces, but new governments proved even worse than traditional ones. A hoped-for two-party regime in which LDP and DPJ would compete for power was not realized. Disappointed, in 2012, people voted back an LDP government led by Abe Shinzo, who held the top office earlier but had to resign due to illness. Fully recovered, Abe emerged as a vigorous and very powerful prime minister in his second and third term, introducing many initiatives and visiting a large number of countries. His energetic way, in stark contrast with incapacitated opposition parties, won the hearts of Japanese people even though they did not fully agree with many of his agendas. Abe was a conservative politician interested in boosting national pride, active engagement in regional security, opposing Chinese military advances, and pursuing Japanese business interests at home and abroad. He began to yield strong and unilateral power over his party and central government in place of collective and bottom-up decision making of the past. As of 2017, LDP, in coalition with Komeito Party, has absolute majority in both Houses[5], which allows it to pass any law it pleases subject to time, popular sentiment and the absence of serious political scandals.

Abenomics was the most prominent economic initiative of his government. As soon as Abe came to power for the second time in December 2012, he launched the initiative for the purpose of ending deflation and reviving growth. Although Abenomics contained nothing really new, it was presented far more effectively than any other previous economic package. It consisted of three "Arrows"—aggressive monetary policy in "different dimension," flexible (i.e., active) fiscal policy and new growth strategy. In March 2013, Abe appointed Kuroda Haruhiko as Bank of Japan Governor who immediately began to execute the Monetary Arrow of Abenomics. Kuroda declared an inflation target of 2 percent, to be attained in two years, and promised to double monetary base and the central bank's government bond holding, also in two years. With this monetary expansion, the extremely high yen was also to be corrected. For the Fiscal Arrow of Abenomics, investment in infrastructure was increased under the slogan of revive economy first, consolidate budget later. To implement the Growth Arrow, the Japanese Economy Revitalization Headquarters and the Industrial Competitiveness Conference were established, and the Cabinet approved the Japan Revitalization Strategy featuring three Roadmaps and three Plans in June 2013. From then on, it became customary to add, adjust or otherwise revise the Growth Arrow of Abenomics annually around June.

Abenomics was enormously successful in its first several months in uplifting national

[5] As of this writing (April 2017), LDP holds 61.9 percent and Komeito holds 7.4 percent of 475 seats in the House of Representative, and LDP has 47.1 percent and Komeito has 8.3 percent of 242 seats in the House of Councilors. The term of the House of Representatives is four years, with the last election taking place in December 2014. The term of the House of Councilors is six years with half elected every three years, with the last batch elected in July 2016.

psychology, pushing up the stock market and depreciating the yen. These collectively improved business sentiment and conditions. Corporate profits rose, tax revenue increased and unemployment started to fall. Abe naturally took full credit of these improvements. The Monetary Arrow of Abenomics was particularly praised by such foreign and domestic economists as Joseph Stiglitz, Paul Krugman, IMF Managing Director Christine Lagarde, US Fed Chairman Ben Bernanke, Takenaka Heizo, Hamada Koichi and Ito Takatoshi. However, there were also skeptics like George Soros, Okina Kunio, Ueda Kazuo and Kono Ryutaro who pointed to future risks and uncertainties associated with such a bold monetary move as well as the problem of the broken monetary transmission mechanism (see above).

One problem associated with inflation targeting was that the Bank of Japan was only a small part of factors that determined the inflation rate. Actual inflation rose somewhat, then fell back to the zero-to-negative range, missing the 2 percent target by a wide margin. The Bank of Japan extended the deadline beyond the second year, shifted to negative (rather than zero) interest rate policy, introduced a policy rule centered on long-term interest rates, then finally admitted that 2-percent inflation might be unrealistic for some time to come. Unmoving prices were blamed on the declining global oil price (which was actually good for the Japanese economy), the negative impact of (modest) consumption tax increase and uncertainty surrounding the growth potential of emerging economies.

Yet, most criticism of Abenomics was directed to the Growth Arrow. Macroeconomic policy is not an end in itself but a means to prepare a congenial environment for strong and sustained economic growth. The growth policy therefore should take center stage, but the Growth Arrow of Abenomics was ambiguous, spread-out and continuously shifting. The original version announced in June 2013 had three Roadmaps and three Plans, which branched out to 12 pillars, 37 items and 56 sub-items. They were revised and expanded annually. Proposed actions were not unreasonable but too general and too many without prioritization or implementation details. Many coincided with initiatives frequently adopted by past governments. It may even be said that the Growth Arrow was just a long and evolving wish list whose execution depended on concrete projects of individual ministries which might or might not be proposed or approved. Line ministries rushed to come up with projects that were likely to be approved under the Growth Arrow, carrying such key words as women, childcare, rural area revitalization, foreign trainees, inbound tourism, overseas expansion of small and medium businesses, and so forth. However, these projects were not properly integrated or structured for achieving concrete targets. After several years of adjusting the Growth Arrow, the initial appeal of Abenomics as a Japan revival plan seems to have been lost.

The book comes to a close here, under this somewhat pessimistic tone, leaving the economic development of Japan as an unending story. After traveling a few centuries since the Edo period, with many twists and turns as well as successes and failures, Japan has reached a stage where

obsession with material wealth—catching up with the West or competing with China—is no longer desirable or feasible. Yet mature Japan has many spiritual, communal and other non-material values that are unique but were mostly pushed aside in the race to high technology and income. Whether they can be reactivated to produce a new society is yet to be seen.

Box 13. The future of manufacturing SMEs

Small and medium enterprises (SMEs) in the manufacturing sector have been a great value creator in post-WW2 industrialization. While Japan's big-name car, electronics and machinery makers are globally well-known, they heavily rely on the supply of materials and components produced by manufacturing SMEs. Such materials and components require precision, zero defects and on-time delivery, and contribute far more to the product value than final assembly. Japan has many industrial areas where manufacturing SMEs congregate such as Ota Ward of Tokyo, Nagoya and its surrounding areas in Aichi Prefecture, Higashi Osaka, Sakai, Kobe, Amagasaki, Kitakyushu, Suwa and Okaya, Ota and Isezaki, and so on. Some component manufacturers operate independently but many are organized as regular suppliers in a pyramidal keiretsu relationship led by a large parent company.

However, small manufacturers have been in trouble since the bursting of the asset bubble. From around 1990 to most recent observation (2012-13), manufacturing SMEs in Japan shrunk 44 percent in number of establishments, 36 percent in employment and 23 percent in output. Difference in these numbers implies that the average size of firms rose as smallest ones were eliminated or merged. This is a nationwide phenomenon replicated in virtually all industrial areas mentioned above. Multiple reasons are cited for this, including the prolonged post-bubble recession, severe pressure for cost reduction, exodus of large customer companies abroad, recurrent yen appreciation, aging and declining population, high corporate income tax, competition with emerging economies, labor shortage, global economic crises, and so on. Among these, the particularly unique problems facing Japanese manufacturing SMEs are declining orders in the domestic market and the lack of young workers who join and take over the factory. Many SMEs have closed because retiring owners could not find anyone to inherit the business.

For distressed SMEs, one way to survive and even to prosper is to go abroad. This is certainly not the first time Japanese manufacturers went abroad, but the previous waves of overseas investments were carried out mostly by globally well-known giants or their subsidiaries which were encouraged or forced to go with them. Most SMEs remaining in Japan then were passive producers receiving orders and blueprints from large customers and producing and delivering products promptly and in perfect quality. They had high skills and technology but little capacity for making dynamic strategies such as proposing and designing new products, seizing new customers and markets, finding international partners, recruiting foreign managers and engineers, utilizing IT and social networking services, registering and protecting intellectual properties, etc. SME owners spoke only Japanese and seldom travelled abroad. But after the global financial crisis of 2008 (which Japanese call the "Lehman Shock"), even such *machikoba* (small local factories) had to consider going abroad because

orders for their products suddenly vanished. Even so, they had no knowledge or experience to succeed in unknown foreign markets. This situation was very different from manufacturing SMEs in Germany ("Hidden Champions"), China or Taiwan which were equipped with full corporate functions to forge ahead in global markets.

Traditionally, the Japanese government had been hesitant to promote overseas investment of manufacturing SMEs for fear of "hollowing out" of the Japanese industrial base. But seeing the enormous size and irreversibility of the Lehman Shock, it switched to actively supporting such investment. In 2010, the Minister of Economy, Trade and Industry began to host the Conference for Supporting Overseas Business Expansion of SMEs, which compiled and revised a policy guideline in 2011 and 2012, respectively. For the first time, the Japan International Cooperation Agency (responsible for development aid) and the Japan External Trade Organization (in charge of trade promotion) were also tasked to assist Japanese manufacturing SMEs to venture abroad. Not only the central government but local governments, business organizations and NPOs were also mobilized to execute this policy. It soon became a major pillar in Japan's SME assistance package. Information dissemination, business consultation, matching with foreign partners and suppliers, business support abroad, and negotiating and creating business ties with foreign provinces and cities are among the standard measures. Some institutions provide "hands-on" support, or customized and intensive support to overcome initial difficulties for a small number of carefully selected SMEs.

Not all manufacturing SMEs in distress are advised to go abroad. Even with official assistance, international business is a huge challenge for firms with little experience. Prior screening is necessary to pick eligible firms from those that are better off home or those that are truly hopeless. The most important criterion is whether the company boss has a strong will and a reasonable initial plan to start the process. When proper selection is made, there is a good chance that *machikoba* will grow into a larger and more dynamic enterprise in an entirely new environment. This means that Japanese manufacturing will prosper and develop in different soils and cultures. From the viewpoint of developing countries, arrival of high-precision Japanese SMEs is very welcome for learning skills and technology, offering gainful employment to youths and overcoming middle income traps. Vietnam and Thailand are the most popular destinations for Japanese manufacturing SMEs, and Indonesia is additionally popular among Japanese SMEs in the automotive sector. On the receiving side, domestic firms in these countries often crave to partner with Japanese SMEs that will help them with technology and marketing.

Let us look at a few actual cases. Firm A, a precision metalworking factory in Higashi Osaka, hired several *gino jisshusei* (technical intern trainees who stay in Japan for up to three years) from Vietnam starting in 2004. They were diligent and excellent workers. Soon they were hired as full timers. In 2014, the firm decided to build a branch factory in Ho Chi Minh

City by dispatching its Vietnamese staff to their fatherland.

Firm B, a hand tool maker in Tokyo, invested in Vietnam in 1997 while also assisting other Japanese SMEs to come to Vietnam by offering business services and rental factory space. It expanded its own Vietnamese factory in 2008 and built a new rental factory complex nearby in 2014. A naturalized and highly experienced Vietnamese engineer was recruited from Gunma Prefecture to implement these expansions.

Firm C, a metal parts manufacturer in Nagoya, shares its unused factory space in Bangkok, Thailand with other manufacturing SMEs from Nagoya. It provides multiple and flexible support to Japanese SMEs coming to Bangkok, for example, through trading services, matching with local Thai suppliers and a branch office in Nagoya.

In all of these cases, human and inter-firm networking and government support programs contributed, with different intensity and effectiveness, to minimize initial investment cost and risks of overseas investment by Japanese manufacturing SMEs.