

# Chapter 12

## Economic Maturity and Slowdown



Crazy Prices – Consumers rushed to supermarkets to stock up tissue paper and toilet paper, in Minato-ku, Tokyo, 1973.

Japan's high growth came to an end in the early 1970s. Subsequently, the annual growth rate fell to an average of about 4 percent in the 1970s and 80s, and further down to near zero in the 1990s. The government called this "stable growth." Why did growth slow down in the early 1970s?

One important fact that we should keep in mind is that this growth slowdown was common to all industrial countries, including those in North America and Western Europe. Therefore, the reasons for slowdown must have been at least partly global, although domestic factors may also have played a role. In addition, inflation accelerated in all industrial countries in the 1970s. This also points to a globally common cause. Let us look at the domestic and international causes of Japan's slowdown, respectively.

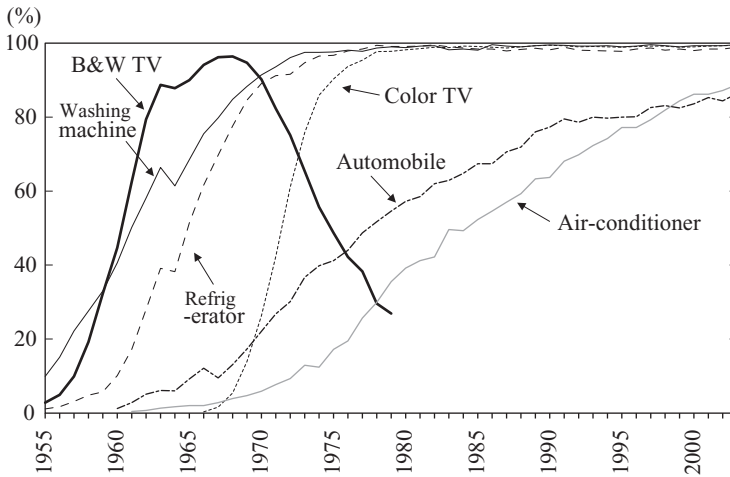
## 1. The end of catching up

On the domestic side, transition to lower growth was natural and inevitable because the Japanese economy had caught up with the US and European economies and matured. During the catching up process, a developing country can (selectively) import technology and new systems which exist in the developed world. But when you become part of the developed world, you can no longer copy others but must create something new in order to grow. Naturally, clearing your own path is harder and slower than following someone else's path.

In terms of per capita GNP (measured in actual dollars, not in PPP dollars—see below), the income ratio between Japan and the US was 1 to 14 in 1950, 1 to 6 in 1960, and 1 to 2.5 in 1970. This narrowing of the bilateral income gap was the result of Japan's much faster growth compared with the US. After the 1970s, the fluctuation of the yen/dollar exchange rate began to disturb this income comparison. The income ratio was 1 to 1.3 in 1980 and 1 to 0.93 in 1990, which means Japanese income was temporarily higher than US income in that year. But since Japanese prices were in general much higher than in the US, this does not necessarily mean the Japanese people had attained a higher living standard than the Americans in 1990.

To make adjustments for different price levels, the concept of *purchasing power parity* (PPP) is used. The same amount of money can buy much

Figure 12-1 The Ratio of Households Owning Consumer Durables



Sources: Cabinet Office, *Trends in Household Consumption*, 2003, and others.

in countries with low prices and only a little in countries with high prices. Consumers in China, where prices are low, could enjoy much higher living standards than consumers in Japan, where prices are high, if they had the same income measured in a common currency. The real income of Japanese consumers must therefore be discounted by the extent that Japanese prices are higher than Chinese. This adjustment is necessary to compare income and living standards across countries correctly. Measured by this PPP criteria, Japan's per capita income surpassed that of Italy in 1966 and that of Britain around 1975. Japan did not overtake the US, West Germany or France but came close to them by the mid-1970s. Thus, it can be said that Japan was firmly in the highest income group by the 1970s.

Another way to measure income is by affordability of consumer durables. It took 10.7 months of average salary to buy a new car (the basic model of Toyota Corolla) in 1966, but Japanese workers had to work only 4.0 months to buy a car in 1974. In 1991, a new car could be had after 2.4 months of working. By the mid-1970s, virtually all Japanese households were equipped with washing machines, refrigerators, vacuum cleaners, telephones and color TVs (automobiles and air-conditioners were not as widely owned because they were not considered necessary for some households).

## 2. The oil shocks in 1973-74 and 1979-80

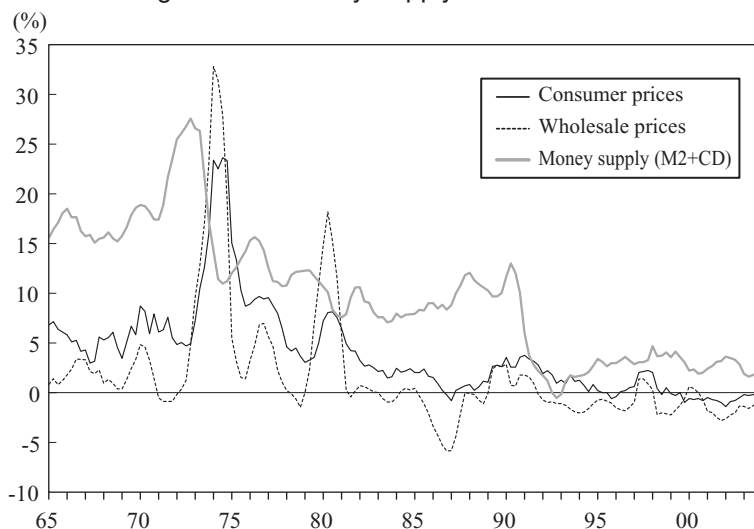
On the external side, there were two major economic shocks in the 1970s which were common to all countries: the oil shocks and the beginning of general floating of major currencies. These are now examined more closely.

The price of crude oil was low and stable for a long time in the post WW2 period. But in autumn 1973, the Organization of Petroleum Exporting Countries (OPEC) decided to raise it dramatically from \$2 to \$11 per barrel and reduced their export volume to industrial countries by about 10 percent. The oil price was again raised to about \$30 per barrel in 1979-80. Both of these price increases were associated with the political and military situations in the Middle East. The first oil shock was the result of the Fourth Middle Eastern War and the second was in response to the Iranian Revolution.

The OECD countries depended heavily on imported oil with the average import ratio of 67 percent of domestic use. However, Japan's foreign oil dependency, at 99.7 percent, was particularly high. In Japan, the first oil shock caused both wholesale prices and consumer prices to surge beyond what could be explained only by the oil impact. Between these prices, wholesale prices rose faster. People were thrown into panic and tried to hoard as many daily necessities as possible, such as toilet paper, soap and kerosene. But this stocking behavior collectively led to empty shelves in supermarkets, although the flow supply was sufficient to cover the flow demand. Seeing empty shelves, people panicked even more. Shortages also spread from consumer goods to industrial inputs. Speculative hoarding by traders was suspected of further accelerating the price increase. This phenomenon was called *kyoran bukka* (crazy prices). In 1974, Japan registered its first negative growth (-0.8 percent) in the postwar period. "Stagflation" was the term that economists used to describe the simultaneous occurrence of recession and high inflation.

On close examination, however, the money supply was increasing rapidly and inflation was already accelerating in the early 1970s, prior to the first oil shock. This was due to the Bank of Japan's foreign exchange intervention to support the dollar (buying dollar assets from the market in exchange for yen assets). The receipt of yen assets by the private sector had the effect of pushing up the Japanese money supply. Moreover, expansionary fiscal policy

Figure 12-2 Money Supply and Inflation



Sources: Bank of Japan, *Financial and Economics Statistics Handbook*; and Ministry of Public Management, *Consumer Price Indices*, various issues.

fueled the inflation in the early 1970s. This was caused by Prime Minister Kakuei Tanaka's "Japanese Archipelago Rebuilding Plan," announced in 1972, which called for massive public investment to construct highways and Shinkansen railways to connect rural areas with urban centers. Fiscal activism created an economic boom and land speculation became rampant along the proposed routes of large-scale transportation projects.

However, in the wake of the first oil shock and "crazy prices," Tanaka's "Rebuilding Plan" had to be abandoned. Monetary policy was also gradually tightened. The Bank of Japan was severely criticized for causing high inflation, and in response, it became more "monetarist." The Bank of Japan began to target monetary growth to avoid inflation as the monetarist school of macroeconomics teaches.

As a part of structural reform, the government tried to reduce energy consumption of Japan and promote "rationalization" (i.e. downsizing and closure) of energy-intensive industries, including paper and aluminum refining. The national campaign was launched to turn off unnecessary lights, set the room temperature lower in winter and higher in summer, and discourage commercial neon signs. However, substantial energy saving would require an over-

all improvement of energy efficiency, not just turning off lights more frequently. This would take time since new technology and capital investment were required. In this regard, Japan's effort to economize energy relative to economic activity turned out to be brilliantly successful in the long run. By the early 1980s, Japan became the most efficient energy user among industrial countries. The Japanese automobile companies also succeeded in mass producing energy-efficient cars, many of which were exported to overseas markets, especially to the US (see the story of Soichiro Honda in the box of chapter 11).

Compared with the first oil shock of 1973-74, the second oil shock of 1979-80 had a relatively minor impact on the Japanese economy. Inflation rose, but not very much, and the economy continued to grow.

### 3. Cause or effect?

Economists debated the nature of the oil shocks. There were two diametrically opposed interpretations, and the debate still remains unresolved. Jeffrey Sachs, Michael Bruno and Barry Bosworth took the position of the supply shock view. Hans Genberg, Alexander Swoboda and Ronald McKinnon supported the global monetarist view.

*The supply shock view:* the first—and perhaps more popular—view of the oil shocks says that they were *supply shocks* caused by OPEC's political power. As the oil price was raised exogenously, the aggregate supply curve (in the standard macroeconomics textbook)<sup>1</sup> shifted up and to the left. This led to higher prices and lower output, namely, “stagflation.” Additionally, aggressive wage increases demanded by trade unions further contributed to global inflation. According to this view, the world had to solve its supply side problems, including energy shortages and wage rigidity, to stabilize the situation.

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<sup>1</sup> In the graph measuring the price level vertically and income horizontally, a downward-sloping aggregate demand curve is derived from the IS-LM analysis, representing the demand side of the national economy. Similarly, an upward-sloping aggregate supply curve is constructed from the supply side using the production function and the labor market. Equilibrium is found where these two curves intersect. An oil shock, if it is to be regarded as a supply shock, shifts the aggregate supply curve upward to the left. The equilibrium point moves in such a way that the price level rises and income declines.

*The global monetarist view:* the alternative view argues that the high inflation was caused by global monetary expansion, which in turn was caused by the breakdown of the Bretton Woods fixed exchange rate system. As the Japanese and European central banks tried to buy up dollars to prevent sharp appreciation of their currencies against the dollar during 1971-73, the money supply was increased in all major countries. Global excess liquidity ignited commodity price inflation even before the first oil shock occurred. The oil shock was the *final result* and not the cause of high inflation, which was generated by the oversupply of global money. OPEC is always aggressive, but attempt to raise the oil price succeeds only when there is too much global liquidity. Thus, the stagflation in the 1970s should be explained by the instability of the international monetary system.

## **4. Floating of major currencies**

The Bretton Woods system (1944-71) was a dollar-based and US-centered fixed exchange rate system. It achieved unprecedented global price stability, high growth and trade liberalization from the 1950s onward. But the system began to show strain in the mid-1960s.

As the US, the center country, began to adopt an expansionary macroeconomic stance, global inflation emerged in the late 1960s. There was downward pressure on the dollar and corresponding upward pressure on gold and the European and Japanese currencies in the foreign exchange market. In August 1971, US President Richard Nixon finally announced that the US dollar was no longer to be fixed to gold and, with this announcement, the dollar began to float. But the Bank of Japan and the central banks in Europe intervened massively to purchase the dollar to avoid the appreciation of their currencies (appreciation meant the loss of export competitiveness of that country). From 1971 to 1973, the world tried to re-peg the major currencies at new exchange parities, but the effort failed. Under severe speculative attacks, the world entered into an era of floating major currencies in early 1973.

The general floating of major currencies has continued to this date. Soon, it was discovered that a pure float was too volatile and injurious to national economies. In 1985, the Group of Five (G5)—the US, Japan, West

Germany, France, and the UK—jointly intervened to lower the overvalued dollar (the Plaza Agreement). In 1987, the Group of Seven (G7)—G5 plus Italy and Canada—again intervened to stabilize the dollar at a lower level (the Louvre Accord). Since then, such joint interventions have been tried occasionally to correct extreme currency movements. Among major central banks, the Bank of Japan has been particularly averse to excessive yen appreciation and often intervened unilaterally to prop up the dollar (by buying dollars and selling yen). This has resulted in rapid accumulation of international reserves to the highest level in the world. Meanwhile, European countries continued to push toward regional monetary union since the 1970s. The historical achievement was completed when the euro was created in 1999 and its paper notes and coins began to circulate in 2002.

The Japanese economy is particularly vulnerable to the fluctuation of the yen/dollar exchange rate for several reasons. First, the yen is a lone floater as there is no yen zone in Asia—unlike the euro area in Europe or the global dollar zone for the US. Second, most of Japan's trade and virtually all of its financial transactions are conducted in dollars. Third, Japan, as the largest creditor country, has accumulated a huge amount of unhedged dollar assets which are concentrated in US government bills and bonds, and whose values depreciate whenever the dollar falls. Fourth, Japanese industries exhibit relatively low *exchange pass-through* (the degree of domestic price response to exchange fluctuations) and their products contain relatively high domestic value-added. When the yen appreciates, their yen-denominated costs also rise almost proportionately, leading to the loss of competitiveness. As a result, Japanese output and investment stagnate, prices and wages are suppressed, and financial strain is created. This situation is called *endaka fukyo*, or high yen-induced recession.

## 5. Delayed systemic reform?

Some economists argue that the Japanese economic system of the 1950s and 60s, based on long-term stable relationships, such as the main bank system, lifetime employment, seniority wages and administrative guidance, became obsolete by the 1970s. This system functioned well while the country was in the catching up process, but was no longer appropriate for a more mature



industrial society. According to them, Japan should have shifted toward a more market-based, less officially guided system during the 1970s.

But two large macroeconomic shocks of oil price hikes and floating major currencies intervened, and the Japanese government was forced to tackle these problems instead of concentrating on systemic transformation. Moreover, trade friction with the West intensified (next section), which further diverted national attention. As a result, the Japanese economy has retained many legacies of the catching-up process, such as over-regulation and the lack of incentives for innovation. This has become an institutional barrier for Japan's further development.

This is one popular view. However, there is an alternative view that cautions against admiring the US-type free economy uncritically. The advocates of this view assert that Japan's transition to a freer market economy, if it is to be done, must be implemented carefully and selectively, without throwing away desirable Japanese features including long-term perspective, teamwork, the *monozukuri* (making things) spirit, and the balanced sense of efficiency and equity.

## **6. Trade friction with the US**

Japan's main external problem in the 1950s to mid-1960s was how to suppress an emerging trade deficit. Phrases like "balance of payments ceiling" and "stop-go policy" discussed in chapter 11 reflect this problem. However, around the mid-1960s, the problem changed 180 degrees—Japan now had to reduce the rising trade surplus as a national priority. The trade surplus was politically undesirable because it angered the US, especially the US Congress and industrial lobbies. In the 1980s, Japan began to record the largest trade surplus and the US had the largest trade deficit in the world, year after year. Furthermore, the size of Japan's surplus and that of the American deficit were similar. Japanese saving was used to finance American overspending, and that became the largest financial flow in the world economy.

The history of Japan's trade friction with the US (and, to a lesser extent, with Western Europe) is long and highly politicized. It began in the 1960s, when Japan was exporting cheap textile products (the "one-dollar

blouse”) to the US market. Japan was forced to adopt “voluntary” export quotas on its textiles. After that, one by one, a series of Japanese goods came under attack: steel, TVs, metalworking machines, automobiles, video players, semi-conductors, and so on. From the 1980s, in addition to the pressure to export less, the US also began to demand that Japan buy more American goods, including farm products like orange and beef, automobile parts, and construction and financial services. The US also argued that the Japanese economic system was inefficient and closed to imports and must be reformed. What started as complaints on individual products thus spread to the universal criticism of the economic system of America’s major trading partner.

The idea that the US trade deficit was caused by Japan’s trade surplus, and that its reduction required bilateral diplomatic negotiations, was behind the tough stance of the US trade negotiators. But was this view correct? Ronald McKinnon of Stanford University and the author refuted this view by presenting the hypothesis of the Syndrome of the Ever-Higher Yen (McKinnon and Ohno, 1997). It stated that neither exchange rate adjustments nor bilateral trade talks could “correct” the bilateral trade imbalance and, if implemented, they would only cause new problems. This view was in the minority in the US but had a broad support among Japanese businesses, officials and economists (see Komiya’s argument at the end of this chapter). More specifically, the hypothesis argued as follows.

- (1) Every five to seven years when the US trade deficit with Japan becomes politically intolerable, the US demands two things: (i) the yen must be appreciated; and (ii) Japan must buy more from and sell less to the US. This situation occurred in 1971-73, 1977-78, 1985-87, and 1993-95. As the US high officials (usually the Secretary of the Treasury, sometimes even the President) talk up the yen, the yen sharply appreciates and the trade tension rises between Japan and the US.
- (2) But this policy reaction only destabilizes the Japanese and Asian economies without solving the US trade deficit problem. The US deficit is a long-term, structural problem caused by the savings shortage of the American government and households. Currency adjustments or trade talks cannot remove this US-made problem. The fundamental solution must come from an American domestic policy to curb

consumption and encourage saving.

- (3) Japan should open up its economy and accept more imports from developing countries, not just from the US, and more FDI from abroad. This would give a strong impetus to Japan's microeconomic and structural reforms. However, it might have little impact on Japan's trade balance which is basically determined by the savings-investment relationship at the macro level<sup>2</sup>. Japan and the US should conclude bilateral agreements to (i) solve trade disputes at the micro or sectoral level (or take them to the WTO); and (ii) stabilize the yen/dollar exchange rate at the level consistent with purchasing power parity.

Since the 1990s, the bilateral policy pattern between the US and Japan has evolved further. In the mid- to late 1990s, the US economy was soaring with an IT boom and an asset bubble, while the Japanese economy was stagnant. The usual US demand to open up Japan and appreciate the yen was in recess, even though the Japan-US trade gap remained very large. It was feared that a further destabilization of the already weak Japanese economy would damage the world as well as the US economy<sup>3</sup>. In particular, the collapse of Japanese financial institutions would have an adverse effect on the international financial system. Since 2004, however, the Japanese economy has shown a sign of recovery. With it, the reason for the US to give Japan a breathing space is also disappearing.

In the late 1990s, some Japanese officials and economists argued for a sharp depreciation of the yen to boost the lackluster economy, since fiscal and monetary stimuli have all failed. However, there is a partner to the exchange

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<sup>2</sup> Denoting exports by  $X$ , imports by  $M$ , savings by  $S$ , and investment by  $I$ , the current account can be written  $X - M = S - I$  using the national income identity. In words, the current account is equal to the gap between the nation's savings and investment. While the current account is the sum of the trade balance, the service account (including cross-border payments of wages and interest) and the transfer account (official grants and private remittances), the difference between the current account and the trade balance was small and stable for Japan. For this reason, the two terms are used interchangeably in this chapter.

<sup>3</sup> In executing economic policies, the US government traditionally abhors an upward movement of long-term dollar interest rates and a decline of the Wall Street stock index, both of which are supposed to dampen investment and consumption and reduce economic growth. Lower economic growth bodes ill for the next election. When such a risk is suspected, the US often softened or postponed its demands on the Japanese side.

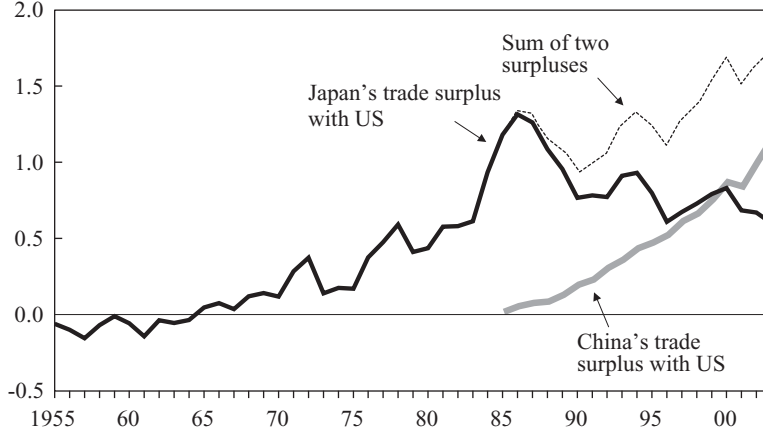
rate. If Japan and the US both desired a yen depreciation, that would be fine. But if the two countries disagreed on whether or how much the yen should fall, or if each wanted a depreciation of its currency against the other, the outcome would become highly uncertain. In reality, despite the hope of driving the yen down, the yen actually strengthened against the dollar in 2003 and 2004. In the mean time, the US government continued to send very ambiguous signals on the desired movement of the dollar. It repeated that the strong dollar policy would be maintained but the exchange rate should be determined by the market.

Another important fact is that China has overtaken Japan as the largest trade surplus country vis-à-vis the US around the year 2000 and, as a consequence, trade friction similar to what Japan experienced in the past has emerged between China and the US. As long as the American savings shortage remained unresolved, some other country would be obliged to provide a sufficiently large trade surplus (i.e. international lending) for the US, if Japan were not to do it. China has begun to have skirmishes with the US over human rights, intellectual property rights, and other commitments made at the time of WTO accession. Moreover, as predicted from the hypothesis of the Syndrome of the Ever-Higher Yen, the US now strongly demands an appreciation of the Chinese renminbi (RMB) to “correct its gross undervaluation” and diminish Chinese competitiveness. Since China is still a developing economy with tight capital control, the situation is not exactly the same as Japan. But it can be said that currency management under mounting US political pressure has now become one of the major policy questions for the Chinese monetary authorities.

In July 2005, China revalued the RMB by two percent and officially moved from the fixed exchange rate system to the basket currency system with unannounced basket contents. However, the actual mode of currency management did not change significantly. The RMB still remains virtually fixed to the dollar and its speed of crawl has been very slow at the time of this writing (late 2005). In light of China’s unbending inclination toward gradualism, this is quite expectable. How soon and by how much the RMB will start to fluctuate by market forces remains an open question.

Earlier, Japan was the target of global criticism because it was too strong. Since the 1990s, Japan has been weak and stopped drawing much atten-

Figure 12-3 US Bilateral Trade Balances with Japan and China  
(% of US GDP)



Source: US Census Bureau.

tion from foreign governments. This change is described as “Japan bashing” turning to “Japan passing.” The Japanese like self-depreciation and are very sensitive to how others perceive them.

## 7. Fiscal expansion and consolidation—and expansion again

During the high growth period of the late 1950s to 60s, the central government budget was generally sound. It was in surplus and no government bonds were issued until 1965. But in the mid to late 1970s, fiscal expansion to stimulate the economy was re-activated, financed by the issuance of new government bonds. These bonds were initially of 10-year maturity but bonds with shorter maturities were also issued later. Public debt quickly accumulated.

In the 1980s, the Japanese Ministry of Finance started an initiative for fiscal consolidation. A tighter budget and bold expenditure cuts were targeted. Fiscal and administrative reforms were proposed and partly carried out. The Second Ad Hoc Commission on Administrative Reform (*Dai Ni Rincho*, 1981-83), an official advisory organ headed by former Keidanren President Toshio Doko, recommended expenditure cuts without tax increases for fiscal consoli-

dation. His recommendations also included greater international contributions through increased ODA and military spending, reduction of healthcare costs, and private-sector initiatives. Mr. Doko himself was a man of self-discipline and modest living. He ate only a small dried fish for breakfast, thus setting an example for the government to follow.

Subsequently, the Maekawa Report (1986-87) was prepared by the Advisory Group on Economic Structural Adjustment for International Harmony, a private group advising Prime Minister Nakasone headed by former Bank of Japan Governor Haruo Maekawa. It recommended expansionary fiscal and monetary policies to boost domestic demand, economic deregulation, and reduction of the trade surplus to avoid friction with the US. His low interest rate policy was later criticized as causing an asset bubble. In addition, Prof. Ryutaro Komiya severely criticized Mr. Maekawa's recommendation for a trade surplus reduction, arguing that the surplus was a macroeconomic phenomenon which should be left to market forces (see the box below).

Thanks to the efforts of the Ministry of Finance and the asset bubble in the late 1980s, the fiscal balance gradually improved. However, with the bubble burst in 1990-91, the Japanese economy plunged into a long recession. A series of fiscal stimuli were tried in increasingly large amounts in the 1990s and public debt began to accumulate again.

## Prof. Komiya and the Japan-US trade friction

Prof. Ryutaro Komiya (1928-) is one of the most prominent economists in Japan. After graduating from Tokyo University, he conducted research at Harvard University, Stanford University and Aoyama Gakuin University, among others. He was a professor as well as the Dean of the Faculty of Economics at Tokyo University. He also served as the President of the MITI's Research Institute of Economy, Trade and Industry (RIETI).

Prof. Komiya's main research area is international economics. In addition to theoretical works, he has written many books which criticized the policies of the Bank of Japan and the Japanese and US governments. In his 1994 book, *Economics of Trade Surplus and Deficit*, he flatly dismissed the idea that Japan's trade surplus was generated by the closed nature of Japanese markets. He argued that the trade gap was fundamentally a macroeconomic phenomenon of the savings-investment balance. He asserted that, unless the US adopted internal policies to increase its own saving rate, no trade negotiation or exchange rate manipulation would "resolve" the trade gap issue. He also criticized the Maekawa Report as completely misguided. This view is quite close to the Hypothesis of the Syndrome of the Ever-Higher Yen of McKinnon and Ohno (1997) presented in the main text.

Here are some excerpts from his book:

Let me reflect on why I am writing this book. My current position is roughly as follows. For more than a decade since around 1983, Japan's huge current account surplus and America's huge deficit—or Japan's trade surplus with the US—have been a cause of economic "friction" between the two countries. Against this trade surplus of Japan, the US has aggressively demanded that we reduce the surplus and open up the Japanese market.

To me, first of all, these demands for reducing the surplus and opening the markets—or more precisely, the ideas behind these demands—seem extremely illogical and unreasonable. Japan's response to the US in the so-called Maekawa Report in 1986 was also highly inappropriate.

Second, from the viewpoint of economics, the debate over the bilateral current account imbalance is full of elementary mistakes. Stupidity and nonsense rule this debate. And I believe it is my mission as an economist to correct such mistakes and nonsense.

Third, I consider myself an internationalist and not a nationalist, and I am proud of it. But I cannot endure the situation where Japan is unduly criticized by the international community based on misunderstanding, prejudice and malice. I want to refute such criticisms and correct these misguided ideas. (pp.3-4)

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Recently, there is a re-emergence of the idea that yen appreciation can reduce Japan's trade surplus. But this idea is fundamentally mistaken. The exchange rate can adjust only the cyclical part of the surplus, if that. In a floating exchange rate system, the (real) exchange rate is endogenous [determined by the interaction of many variables] and cannot be manipulated to an arbitrary level. (p.106)

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In general, the impact of the real exchange rate (in other words, the terms of trade) on savings and investment is ambiguous... As a first approximation, I propose to presume that the terms of trade has no direct relationship with the trends of S [saving] and I [investment] in each economy... Existing theoretical and empirical studies on savings have not considered the effects of changes in relative prices or the terms of trade on the trend of savings, because such an inquiry is theoretically a very remote one. (pp.180-181)



# Chapter 13

## The Bubble Burst and Recession



The bankruptcy of Yamaichi Securities – President Nozawa announces the decision to voluntarily close the operation in a press conference, 1997.

## 1. The lost decade and the debate over reforms

Japan experienced an asset bubble in the late 1980s. As the bubble burst around 1990, the Japanese economy entered a long period of deflation and recession. Growth slowed down and sometimes became even negative. For the first time in the postwar period, prices declined persistently. Economic statistics remained gloomy and, more importantly, consumers and producers became extremely 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 2000s was less than expected.

The 1990s is sometimes called the Lost Decade for Japan. Naturally, the main topic for Japanese economists was why this recession continued and what should be done to end it. The key policy issue seemed to be whether or not bold reform measures should be taken at a time when the economy was stagnant. Some argue that painful reforms were necessary precisely when we faced a recession. Others argued that such reforms should not be carried out under bad economic conditions. But there may be other important issues than this.

The government of Prime Minister Junichiro Koizumi (2001-) is trying to push "reforms" forward. These include privatization of post offices, putting a stop to over-generous highway construction, pension reform, local government reform, and of course, bank reform. The worsening of the economic condition in 2001 due to the global IT recession and the terrorist impact increased opposition to the Koizumi initiative. In 2003 and 2004, economic indicators began to pick up and momentum for reforms was revived. In 2005, the bill for privatizing post offices was passed through the Diet after Mr. Koizumi ousted his opponents from his party in a high-handed political maneuver—and people seemed to support Mr. Koizumi strongly.

It is too early to judge whether these reform efforts really amount to a historical milestone. But it is possible to raise another question—are these reforms sufficient to revitalize the Japanese society? Mr. Koizumi's initiatives are concentrated in domestic administrative reforms to shrink the size of the government. That is certainly important, but what about the other goal of

improving competitiveness of the private sector in the age of globalization? The current government seems to lack leadership and vision in international economic policy. Such crucial issues as building a productive relationship with China, active engagement in WTO and FTAs, revitalization of the East Asian production network, and the way to cope with weak domestic industries under global competition, are not given proper direction. Their management is now left to the operational handling of individual bureaucrats in charge, instead of being guided consistently from the top. A slimmer and more efficient government is fine, but Japan's rejuvenation will not be possible if the dynamism of its industries and agriculture remain suppressed.

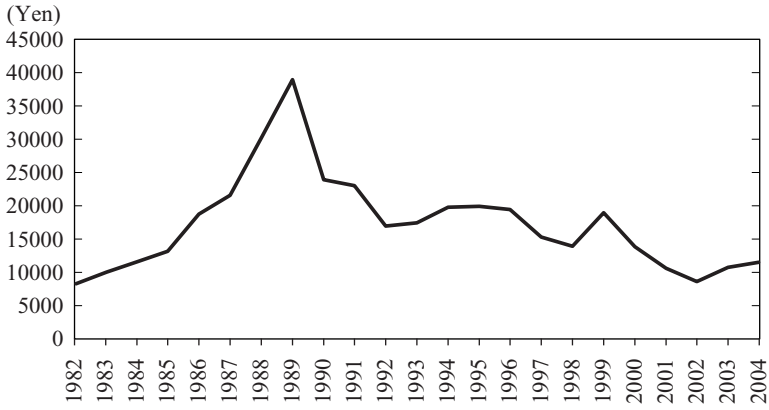
Another problem is the convoluted relationship between the Prime Minister and the ruling party. While Mr. Koizumi is pro-reform, his party, the Liberal Democratic Party (LDP), is mostly and traditionally anti-reform. This is expectable since the LDP's power has depended so much on distributing money to rural precincts. Using pre-war terminology, Mr. Koizumi is trying to implement *Minsei Party* policies as a leader of the *Seiyukai*-like party (see chapter 9). But because Mr. Koizumi is popular among people, old LDP politicians are obliged to "support" him to secure votes, although they disagree with his policies. Mr. Koizumi in turn stays with the LDP to take advantage of its organization and influence. Thus, it is not very clear what message the voters are sending to the government when they support the LDP: is it pro-reform or anti-reform?

## 2. The occurrence of the asset bubble

The Japanese stock price index began to rise in the early 1980s and continued to rise to more than five times the 1980 level. Then, from 1990 it started a long period of decline with medium-term fluctuations. The Japanese land prices also rose throughout the 1980s. The average land price more than doubled. The turning point for land prices came one year later than the stock market, 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.

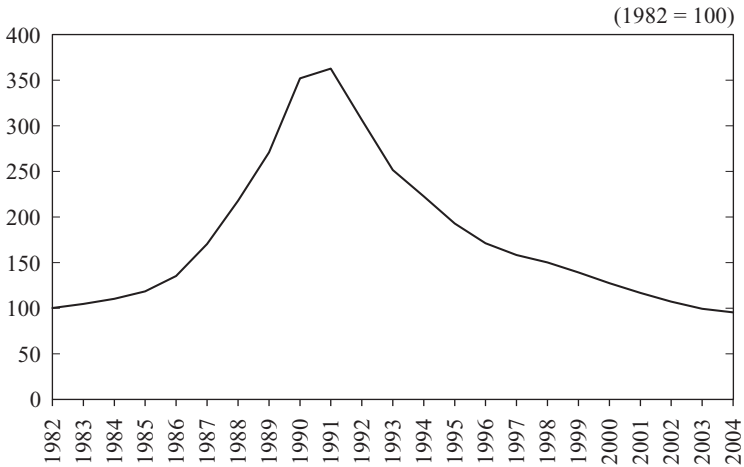
There are two alternative views regarding the cause of the asset bubble.

Figure 13-1 Nikkei 225 Stock Index Average



Source: Nihon Keizai Shimbunsha (Japan Economic Journal).

Figure 13-2 Urban Land Price Index



Source: Japan Real Estate Institute.

The first view argues that the bubble was *caused structurally through bank deregulation*. Previously, Japanese banks were tightly regulated by the Ministry of Finance. There was little incentive to innovate, but as long as the banks remained in this regime, they were assured of an adequate profit margin and protected against bankruptcy. But this system was removed in the early 1980s. As competition began, banks lost the “rents” and “franchise value” of

being a bank (i.e. extra profits given to a (protected) bank). At the same time, large corporate customers moved away from bank borrowing toward other financing, including retained profits, corporate bond issuance and access to international financial markets. As the Japanese banks lost large corporate customers, they rushed to find new—and more risky—borrowers and projects such as small and medium enterprises (SMEs) and land and property investment (especially urban office buildings and rural resort development). But the Japanese banks lacked the ability to correctly evaluate these new borrowers and projects. When the economy was booming in the late 1980s, they over-lent. Business strategy tends to be less careless when the economy booms and problems are concealed. When the bubble ended, these loans became a huge mountain of bad debt (Yoshitomi, 1998).

The second view, which is perhaps more popular, is basically a *monetary explanation of the bubble*. It simply says that easy money in the late 1980s caused the asset bubble. In 1985 there was a sharp yen appreciation, and the Bank of Japan lowered short-term interest rates and eased money in response. The Bank of Japan's policy reaction function (how it decides its policy) is such that traditionally, monetary policy becomes expansionary at the time of yen appreciation or domestic recession. The Bank of Japan's action in 1985 and beyond was in accordance with this rule. Many blame the Bank of Japan, especially Governor Satoshi Sumita, for easing too much and for too long. But since 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 price increase everyone was enjoying. This was a signaling problem: when asset prices rise but goods prices remain stable, is liquidity excessive or not? The data shows that the growth of broad money (M2+CD) accelerated to more than 10 percent during 1987-89. This seemed a little too high for an economy growing at about 4 percent. From the end of 1999, the new Bank of Japan Governor Yasushi Mieno deliberately tightened money and raised interest rates. This quickly ended the bubble. Some criticized Mr. Mieno for his brutality, but could the bubble have gone on forever? It had to end some time, and perhaps the sooner the better.

These two explanations are not mutually exclusive. Bank deregulation explains why reckless projects began to be financed at first and monetary expansion explains why this bubble continued for so long. They are structural

and macroeconomic reasons, respectively, which together caused the rise and fall of the asset bubble.

During the late 1980s, which was the rising phase of the bubble, many queer phenomena were observed.

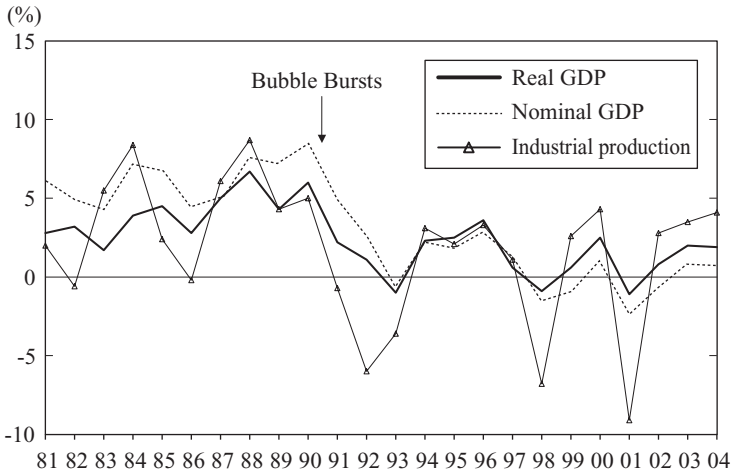
- Those who owned land became very rich and those who didn't had little chance of buying their home. This increased the sense of inequality and social injustice.
- Enriched people purchased luxury goods and consumed expensive dresses and food. They traveled all over the world to spend money—a parallel with the *narikin* during WW1.
- Since vacant land, which was easier to sell, was more valuable than built land, the *yakuza* (Japanese mafia) was mobilized to demolish buildings illegally and force 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. They stood empty for many years to follow.
- A large number of amusement parks and resort hotels were developed. The only hugely successful amusement park in Japan remains Tokyo Disneyland. All others got into financial trouble and many of them are now closed. Some of them are operating under financial distress with a new management: for example, Huis ten Bosch (Dutch theme park in Nagasaki), Phoenix Seagaia Resort (seaside complex in Miyazaki), and Alpha Resort Tomamu (winter sports resort in Hokkaido).
- A large number of male construction workers from the Middle East, especially Iran, came to work in Japan. Some of them had work permits but others were illegal. Every weekend they gathered in Ueno Park in Tokyo to enjoy themselves and exchange information.

But after the bubble burst, these phenomena all disappeared.

### 3. The decade-long recession and deflation

GDP statistics and the industrial production index reveal that business conditions were not uniformly poor during the lost decade. The Japanese economy declined three times, in 1992-93 after the initial bust of the bubble, in 1997-

Figure 13-3 GDP and Industrial Production



Sources: Cabinet Office, and Ministry of Economy, Trade and Industry.

98 following the consumption tax hike and 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 recover. But each time, the recovery was short-lived. The three troughs and intervening mini-recoveries are also clearly visible from other statistics such as machinery orders, housing starts, workers’ income and unemployment. However, the severity and timing of fluctuation differed slightly from one indicator to another. Not surprisingly, small businesses consistently faced greater difficulties than large enterprises, for instance, in enterprise financing and output demand.

For example, in 1996 Japan’s real growth registered 3.5 percent which was highest among the G7 countries. This period also coincided with the relatively weak yen, which was good for Japanese exporters. But 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 (it is very strange that such a small tax increase had such a huge impact). Toward the end of 1997, a number of major financial bankruptcies occurred. Yamaichi Securities and Hokkaido Takushoku Bank went bankrupt, triggering a nationwide banking crisis and credit crunch.

In the following year, the Long-Term Credit Bank and the Securities and Credit Bank also fell. The hope for recovery was dashed.

The big question is: why did the Japanese economy remain so weak for so long after the bubble burst? Economists are still debating. The list below summarizes the most popular explanations.

- One explanation is purely cyclical. Since the bubble period created large overcapacity, it would take time to reduce capital stock and inventory to normal levels. But if so, stock adjustment took a little too long.
- Another explanation blames non-performing loans held by banks. Since banks failed to get rid of bad debt, and since the government did not have proper measures to encourage this, financial intermediation was impaired which in turn hurt the real economy. This vicious circle would continue until a bold measure to clean up the banks' balance sheets was taken. The government claimed that this was being done, but perhaps it was not enough.
- Another popular explanation is that Japan's economic system had become obsolete. Japan's relational systems, such as lifetime employment, seniority wages, keiretsu groups, subcontracting, and so on, might have worked well during the 1950s and 60s, but they have become ineffective in the age of globalization. Some argued that Japan was facing the third major transformation (the first was in Meiji, the second was post-WW2 reforms). But others caution that Japan should not adopt the American system uncritically, since some Japanese systems are still useful. Recall the debate on the origin of the Japanese system in chapter 9.
- Yet another explanation points to long-term changes in the Japanese society. Japan has a rapidly aging population and snowballing government debt. The Japanese people are uncertain about their future, especially concerning the rising tax burden, availability of jobs, and the sustainability of medical care and pension schemes. This pessimism slows down consumer spending and business investment.
- More recently, the emergence of China as the factory of the world and the "hollowing-out" of Japanese manufacturing (the exodus of factories and jobs to other countries) were cited as a great threat. However, China's high growth will not continue forever and China has many internal economic,



social and political problems.

It is probable that Japan's stagnation was the result of these problems in mutual interaction. But if one ultimate cause behind these problems is to be cited, that must be the lack of political leadership. Japan did not have a person at the top of the political system who could clearly identify these problems, explain the situation to the people in plain and persuasive language, and design and implement long-term solutions. Japan's problems were not particularly intractable compared with the problems that other countries face. The continuation of uncertainty and anxiety in Japanese society must be explained by the quality of leadership rather than the difficulty of problems. Japanese people just do not believe that the current government can manage these problems.

## **4. Financial crisis and monetary policy**

In the early 1990s when the asset bubble collapsed, Japanese banks which previously lent actively to small and medium enterprises and property development projects got into trouble. The recession and corporate bankruptcies increased bad debt, and the decline of land and stock prices additionally hurt the balance sheets of banks. Japanese banks often required land as loan collateral and engaged in mutual stock holding, but the values of both assets plummeted. As non-performing loans accumulated, many Japanese banks faced difficulty in observing the 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 wants to remain an international bank. If this ratio falls below 4 percent, the bank is not allowed to conduct even domestic business and must close.

By late 1997, the fear of bank defaults had spread. As Yamaichi Securities and Hokkaido Takushoku Bank went bankrupt, the fear turned into reality. Banks tried to improve their BIS ratios by reducing risky assets. This was done by lending less, especially to small and medium enterprises. But this led to a credit crunch in the real sector, 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," which is 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 safer ones and postal savings.

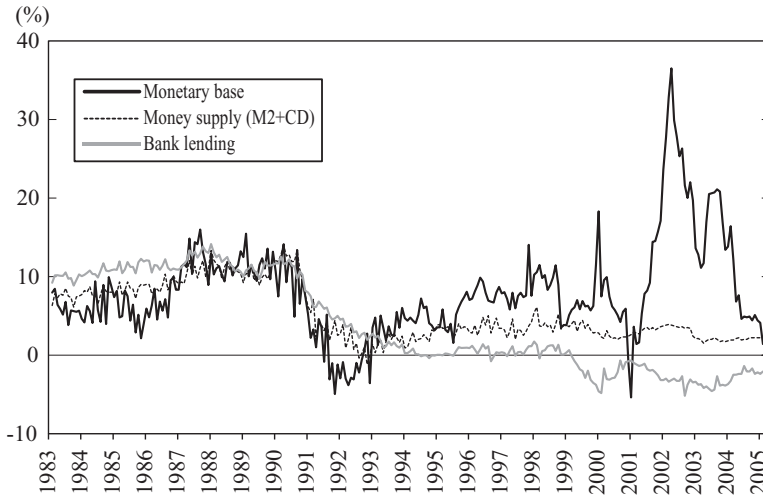
In response to the 1997-98 banking crisis, the government created the Financial Supervisory Agency in October 1998 and the Financial Restructuring Commission in December 1998. They were later merged into the Financial Services Agency in 2000. The government also prepared “public money” up to 60 trillion yen (12 percent of GDP) to deal with the bad debt problem, recapitalize banks and manage the closure and merger of weak banks.

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. This meant that the short-term interbank rate (the *call rate*), which the Bank of Japan could control, was lowered to zero except for a very small technical margin. The Bank of Japan tried to end this policy in August 2000, but when the economy further worsened it was forced to return to the zero interest rate policy. 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 since 2001. The financial panic subsided in early 1998, but general recession persisted into the 2000s.

Since interest rates could not be reduced below zero (if that happened, people would hold only cash), the Bank of Japan seems to have reached the end of its policy rope. However, there was still strong pressure on the monetary authorities to do more to stimulate the economy. For example:

- *Increase the money supply* more drastically and by any means. To do so, buy untraditional assets in open market operations including bank and corporate bonds, foreign bonds, mortgage bonds (and even stocks?). Previously, the Bank of Japan bought and sold only government bonds for the reason of safety.
- *Inflation targeting*: according to the proponents of this idea, the Bank of Japan should announce a positive target rate for inflation for the next 2-3 years and be held responsible for achieving it. At the same time, the Bank of Japan should be insulated from the political pressure of the government. Inflation targeting is considered necessary to change people’s expectations about future inflation. Paul Krugman (Princeton University), Alan Meltzer (Carnegie-Mellon University), Takatoshi Ito (Tokyo University), and

Figure 13-4 Money Supply and Bank Lending



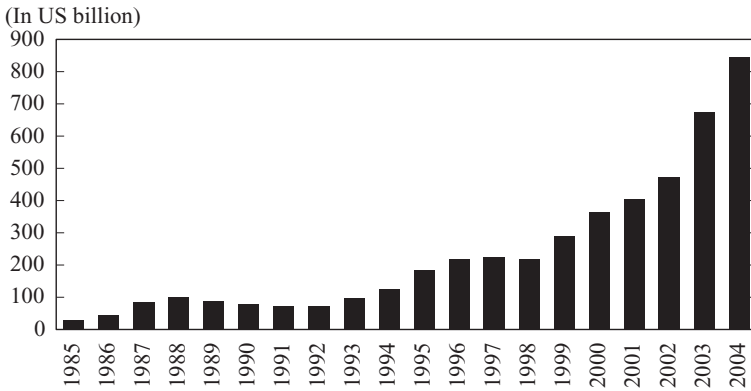
Source: Bank of Japan, *Financial and Economic Statistics Handbook*, various issues.

Motoshige Itoh (Tokyo University) supported this idea. But others, including Bank of Japan economists like Kunio Okina and Kazuo Ueda, were skeptical, saying that even if the Bank of Japan tried, there would be little impact on expectations because the monetary transmission mechanism was broken<sup>1</sup>. Worse, if people's expectations suddenly changed, for whatever reason, after too much liquidity was injected, the resulting inflation would become uncontrollable.

- *Yen depreciation*: according to this view, aggressive monetary expansion, coupled with a political statement to welcome yen depreciation, will improve Japan's competitiveness and stimulate domestic and foreign demand. The government and the Bank of Japan sometimes seemed to endorse this strategy, and the yen actually depreciated moderately when such a policy intention was announced. But clearly, currency depreciation is a beggar-thy-neighbor policy and will hurt Japan's trading partners. If

<sup>1</sup> As Figure 13-4 shows, the relationship between the monetary base, which the Bank of Japan controls, and the money supply or bank lending, which are important for macroeconomic management, has been highly unstable since the 1990s. A massive injection of the monetary base by the Bank of Japan did not lead to an increase in the money supply and bank lending actually continued to decline. The argument that further injection of liquidity without removing the cause of this gap would lead to no result is convincing.

Figure 13-5 International Reserves



Source: Ministry of Finance.

the United States opposes the yen’s further weakening, this policy will have to end. Asian neighbors will also be annoyed. One variation of this idea is to ask China to appreciate the Renminbi, instead of depreciating the yen, to get the same relative effect. However, exchange rate adjustment is unable to solve the long-term structural problem of any country, be it Japan, China or the United States (chapter 12). It often diverts attention from the real cause of economic weaknesses.

In recent years, the Bank of Japan intervened very aggressively in the foreign exchange market to curb the appreciation of the yen. Thanks to this massive purchase of dollar assets, Japan’s international reserves increased dramatically from \$470 billion at the end of 2002 to \$674 billion at the end of 2003 and to \$845 billion at the end of 2004. This is the largest international reserves in the world, although China’s is catching up rapidly.

Meanwhile, American exchange rate policy under the Bush Administration remains ambiguous. The US has repeated the odd statement that “the strong dollar policy is unchanged, but exchange rates should be determined by the market.” The message is unclear and there seems to be no consistent currency policy behind it. Past observations suggest that the US usually feels comfortable when the dollar is moderately weak, especially in the election year. But when the dollar starts to fall greatly due to market pressure, will the US welcome it or resist it?

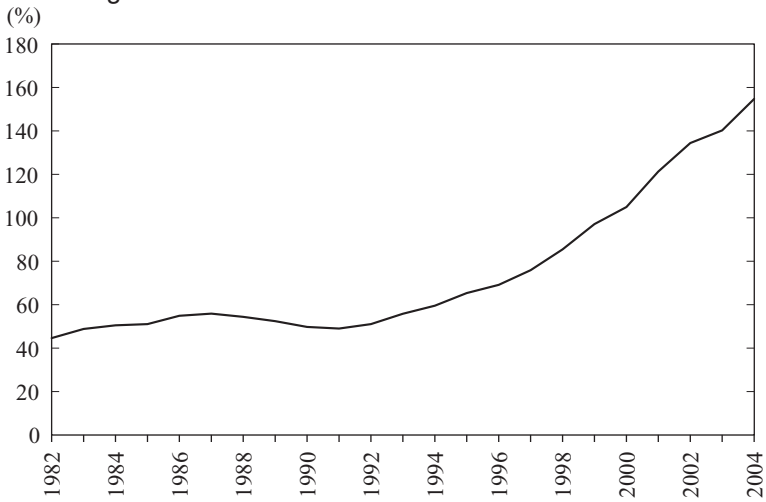
## 5. Fiscal policy

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 2004 (i.e. March 2005), outstanding government debt stood at 782 trillion yen or 155 percent of GDP. This ratio is the highest among major industrial countries. It is highly uncertain whether this public debt explosion can be slow down in the future, let alone reversed. Moreover, this figure does not include short-term debt or *contingency liabilities*, namely, the amounts that the government will be obliged to pay in the future for rescuing the bankrupted social security system, recapitalizing insolvent banks, and so on. International rating companies have continuously downgraded the Japanese government bond in recent years.

The government is often torn between the need for fiscal consolidation and the need for fiscal stimuli. In recent years, Japan's fiscal policy leaned toward expansionism because of the worsening economic situation. There was a strong political pressure for more fiscal stimuli to avoid a "deflationary spiral" (price deflation and output recession in a vicious circle). Many contended that no reform was possible unless the economy improved first. But the effectiveness of fiscal policy under such circumstances is an open question.

The opponents of fiscal activism said that Japan had already tried fiscal stimuli many times during the last decade, but the economy had failed to recover strongly. They also argued that old-fashioned fiscal spending, such as building expensive but under-used highways, bridges, airports and Shinkansen tracks would only benefit rural construction companies while national debt snowballed (did Japan really need three giant bridges to span the Inland Sea?) Further fiscal stimuli, which would add to the already huge government debt, might actually weaken the economy through increased fiscal vulnerability and unsoundness. The LDP-based political system, where votes are secured by channeling fiscal spending toward rural supporters, should be ended, it is said. Whether Mr. Koizumi can break through this dilemma while staying within LDP, the den of anti-reform politicians, is yet to be seen. In 2003, Mr. Koizumi seems to have been successful in tightening the fiscal stance relative to previous years—but not in 2004.

Figure 13-6 Government Debt as Percent of GDP



Sources: Bank of Japan, and Cabinet Office.

Under these circumstances, traditional IMF conditionality would require Japan to boldly tighten its budget despite short-term pain. But Japan is the biggest lender in the world with the largest international reserves, and it does not need IMF loans to finance its balance of payments. Consequently, Japan does not have to listen to IMF advice. At the same time, the internal political mechanism does not generate any policy options to pay short-term costs to achieve long-term goals. Perhaps that is the crux of the problem that Japan faces at present.

## The road ahead for Japanese enterprises

In the 1980s, the US economy was struggling against international competition and the Japanese economy was booming. Some Japanese businessmen boasted that there was nothing more to learn from the Americans. In the 1990s, Japan experienced a long recession and a banking crisis while the US economy grew robustly thanks to the IT boom. Some cried, “Japan is finished; our economy will lose out to China and hollow out.” Japan is not the only country to have swung from over-optimism to over-pessimism. But Japanese tendency to react too strongly to the comments of foreign observers makes Japan more likely to embrace the two extremes of arrogance and timidity in succession. However, the manufacturing power of Japan, which has been developing since the Meiji period, does not soar or plummet every several years. The true strength of the Japanese economy is far more stable than ever-changing commentaries.

According to Prof. Takahiro Fujimoto of Tokyo University, such over-reaction is caused by the bad habit of analyzing all industries together in a mindless fashion without recognizing the sharp differences among them. He abhors gross questions like “Which country is stronger, China or Japan?” All industries—be it banking, construction, telecom, electronics, or automobile—are fundamentally different from each other. Any argument that ignores this fact is useless.

To properly evaluate the competitiveness of each industry, Prof. Fujimoto advances the concept of *business architecture* (Fujimoto, 2004). The business architecture theory looks at how components are combined. More precisely, business architecture is a “basic design concept to achieve a satisfactory working of any man-made system, and it asks how the system is divided into components, how functions are allocated to each component, and how the interface of interdependence among components is constructed” (Fujimoto et al, 2001).

When there are complex relations among components, there are two alternative directions in designing a product. The first is *modular architecture*, in which the modality of interaction among components is standardized for easy connection. The second is *integral architecture*, in which the complexity of interaction is happily accepted, and improvements are achieved through numerous trials and errors. Generally speaking, modular architecture is suitable for obtaining quick results at low cost

while integral architecture is appropriate for the pursuit of ever-higher quality in the long run. For example, desktop computers are a typical modular product in which globally common components from various companies are freely combined. In contrast, automobiles must be manufactured with integral architecture if multiple objectives such as performance, comfort, fuel efficiency, safety, etc. are to be attained simultaneously. Modular architecture can be further divided into open type and closed type. This distinction depends on whether the interface is publicized broadly or closed within the manufacturer.

	<b>Integral</b>	<b>Modular</b>
<b>Closed</b>	<b>Closed Integral</b> Automobiles, motorcycles, small consumer electronics, video games, etc.	<b>Closed Modular</b> Mainframe computers, machine tools, Lego(children's toy), etc.
<b>Open</b>		<b>Open Modular</b> Computer system and hardware, internet products, bicycles, some financial products, etc.

Source: Fujimoto, 2004, p.132.

The correspondence between products and business architecture is not rigid but evolves dynamically with the business strategy of each firm or country, technical progress and demand shifts. In addition, business architecture often has structural layers in which, for example, modularization may proceed in final assembly while integration may deepen among producers who supply components.

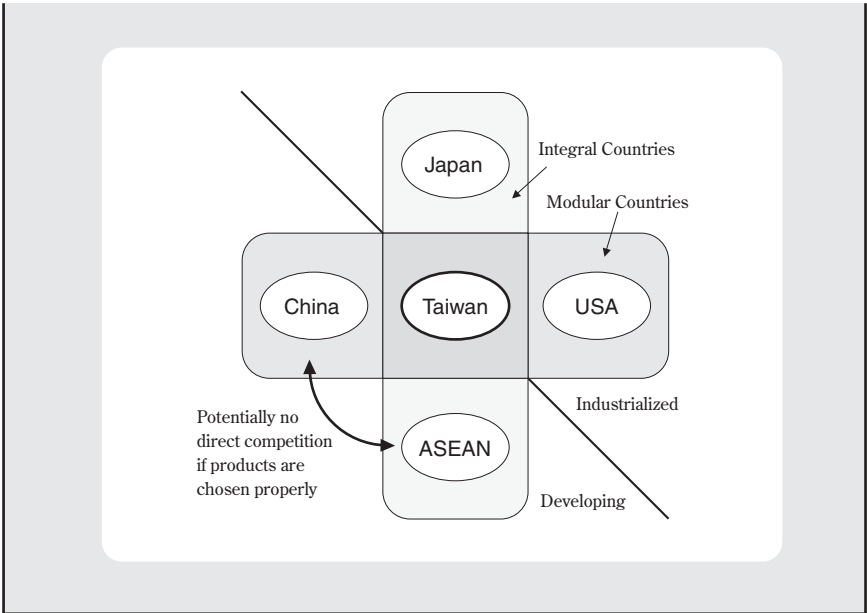
Japan is a country of integral architecture, intensely interested in factory operation and obsessed with the perfection of the product. By contrast, the United States excels in modularization and is good at slicing the product into appropriate parts, standardizing them and making profits on the novelty of the combination. China is also a country of modular architecture, but its comparative advantage comes from labor-intensive modular products rather than from knowledge-intensive modular products as in the United States. Prof. Fujimoto argues that national differences in business architecture come from different institutional capabilities of enterprises in each country. Institutional capabilities in turn have been formed through historical experiences. For instance, in the early postwar period, Japanese firms were compelled to compete and grow without adequate supply of human, financial or physical resources. This led to the practice of long-term employment and the pyramidal suppli-



er system. Note that Prof. Fujimoto's assertion that the Japanese system was created in the postwar period is at odds with another, more popular view that it is a heritage of economic planning during the war period (chapter 9).

Prof. Fujimoto advises Japanese enterprises to stop following fads and to try to match the institutional capabilities they have with the architectural design of the products they produce. Sustained business growth requires making sufficient profits through selling integral products in which Japanese firms excel on the one hand, and strengthening the organizational capabilities that are currently lacking by learning from other firms and countries on the other. The reported emergence of modularized businesses should not lead Japanese firms to abandon the integral capabilities they have nurtured and imitate modularization of others. This would only lead to failure and loss of Japanese quality. If a firm rushes to invest in China simply because rival firms are already there, or because Chinese wages are lower than Japanese wages, the likely result would be low productivity in both Japan and China. What is required is an optimal strategic positioning with the full understanding of the architectural strengths and weaknesses of Japan and China.

Prof. Fujimoto has one concrete suggestion. Since the United States and China are both modular countries but with different levels of wages and technology, they are complementary partners in manufacturing modular goods. Meanwhile, Japan is an integral country with high wages and high technology looking for an international partner. If ASEAN, the traditional destination of Japanese FDI, learns to become such a partner, with a long-term vision and strong aspirations for high quality, Japan and ASEAN can form a strategic alliance in manufacturing integral products which will be differentiated from Chinese products. However, such an alliance remains a hypothetical possibility since no ASEAN countries has acquired necessary skills and attitude for Japanese-style manufacturing. This requires internalizing factory design and operations, ability to maintain, adjust and repair machines, producing parts design and molds, improving the level of local engineers, and so on. In other words, ASEAN must graduate from simple assembly for foreign orders to participation in the manufacturing process in a more fundamental sense. This is the key to upgrading the Japan-ASEAN economic relationship to a higher level. The Japanese government and business community should also actively provide technical assistance and business cooperation for this purpose.



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**FINAL EXAMS**

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Below are the questions I asked on the final exams in the Economic Development of Japan from 1999 to 2004. They are arranged chronologically. Model answers have been omitted because of limited space. Each exam consisted of five required questions and lasted 60 minutes with books closed. I invite interested readers to try. (The average points ranged from 65 to 82 out of 100, depending on the year.)

- Q1 Describe Dr. Tadao Umesao's view on history regarding why Japan became the first non-Western country to industrialize.
- Q2 List political, economic and social conditions existing in the Edo period (by the early 19th century) which later contributed to Japan's rapid industrialization.
- Q3 Discuss the development of agriculture in the Edo period (1603-1867) and how it later helped Japan to catch up with the West.
- Q4 Discuss the formation process of a *nationally unified market* during the Edo period.
- Q5 What was the most important economic goal of the Meiji government (1868-1912)? List policies adopted for that purpose. Approximately when was this goal (more or less) achieved?
- Q6 From 1881 to the mid 1880s, Finance Minister Masayoshi Matsukata implemented a policy initiative called "Matsukata Deflation." What were the contents of this policy, and what were its consequences?
- Q7 Discuss the development, private initiative and official support of Japan's modern textile industry during the Meiji period (1868-1912).
- Q8 What was the role of Eiichi Shibusawa (1840-1931) in Japan's industrialization?
- Q9 Explain the growth of the cotton industry during the Meiji period using the following two terms: "parallel development" and "import substitution."

- Q10 How did Meiji Japan (1868-1912) import Western technology? Did foreign direct investment (FDI) play an important role? How about foreign advisors?
- Q11 Describe the structure of Japan's international trade during the Meiji period (1868-1912).
- Q12 Explain the "Postwar Management" policy adopted after the Japan-China War (1894-95) and also after the Japan-Russia War (1904-05).
- Q13 How were savings mobilized for industrialization during the Meiji period? Did foreign savings (FDI, commercial loans, etc.) play an important role?
- Q14 How did World War I (1914-18) affect the Japanese economy? Discuss its major impacts on industrial growth and financial health.
- Q15 Explain the differences in domestic and foreign policy orientation between the Seiyukai Party and the Minsei Party during 1918-1936. [Before 1927, the Minsei Party was called the Kenseikai Party. For the purpose of answering this question, ignore the name change and use the term "Minsei Party" throughout.]
- Q16 Describe the background, immediate cause(s), and consequence(s) of the 1927 banking crisis.
- Q17 Compare the general economic condition of the 1920s and that of the 1990s. Are there any similarities in the causes of the economic weakness or in how the government responded to it?
- Q18 From the viewpoint of economic planning versus the free market, how did Japan's economic system change during the 1930s and 1940s? Explain its evolution using the following (and other) terms: "Planning Board," "priority production system," and "Dodge Line stabilization."
- Q19 During the war years of 1937-45, what kinds of changes were introduced in the Japanese economic system compared with earlier years? And what was the main *economic* reason for the collapse of Japan's war economy in 1945?

- Q20** In 1947, under the occupation by the Allied Powers, Japan started to implement a land reform. What was its effect on (i) reducing the number of absentee landlords; and (ii) improving agricultural productivity?
- Q21** Immediately after World War II, Japan suffered a triple-digit inflation. Discuss the alternative anti-inflation strategies proposed during 1946-47. Which strategy was finally adopted?
- Q22** What is the meaning of the “rationalization” policy adopted in the 1950s? Why was this policy needed?
- Q23** Describe how the coal industry contributed (or did not contribute) to Japan’s economic recovery and high growth during 1947-1960s.
- Q24** During the postwar high-growth era (late 1950s-60s), how was Japan’s macroeconomic policy conducted, and in what kind of international economic environment? Do today’s developing and transitional economies have a similar environment?
- Q25** Discuss Japan’s monetary policy during the 1950s-60s, with particular attention to the exchange rate regime, balance of payments and price stability.
- Q26** Explain Japan’s exchange rate regime during the high growth period (mid 1950s-1960s).
- Q27** Briefly discuss Japan’s import tariff policy during the entire industrialization period (1860s-1960s). Can we say that Japan achieved industrialization under free trade?
- Q28** Discuss Japan’s macroeconomic problems in the 1990s with particular attention to the banking sector and fiscal and monetary policies.
- Q29** Discuss the effectiveness and limitations of the Bank of Japan’s monetary policy during the last decade (from the early 1990s to the present).
- Q30** Read the electronic news below [next page]. Explain why money supply and bank lending are stagnant in Japan today. Also discuss the Bank of Japan (BOJ)’s policy addressing this problem.

### Money Supply Growth in 2003 Slowest in Decade

Despite the continued policy of quantitative monetary expansion, money in circulation is not growing. According to a Bank of Japan report on Jan.13, money supply grew only 1.7% in 2003 compared to 3.3% in the previous year. This is the lowest monetary growth in ten years. Bank lending also recorded negative growth for the seventh year in a row. It is certain that future monetary policy must cope with the problem of stagnant money... The broad liquidity measure (covering “M2+CD,” postal savings, investment trusts, government bonds, etc.) also grew only 1.1% in 2003, the slowest since 1981 when comparable statistics became available. (Nikkei Net, 11:12 am, January 13, 2004; translated by K. Ohno)

