JAPAN Since 1980

THE WORLD SINCE 1980

Thomas F. Cargill and
Takayuki Sakamoto

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This book tells the story of the performance of Japan's economic and political institutions starting in the late 1970s through late 2007. The authors explain how Japan's flawed response to new economic, political, and technological forces, requiring more open markets and political institutions, ushered in almost fifteen years of economic and financial distress and lost economic and financial development potential from 1990 to 2005. Japan's impressive economic performance in the 1980s in fact masked an "accident waiting to happen": the burst of the bubble in equity and real estate prices in 1990 and 1991. Japan's iron triangle of politicians, bureaucrats, and client industries, combined with a flawed financial liberalization process and policy errors by the Bank of Japan and the Ministry of Finance, brought Japan to an abyss of deflation, recession, and insolvency by the late 1990s. The turning point was the election of Koizumi as prime minister in 2001. Koizumi took advantage of important institutional changes in Japan's electoral system and policy making and implemented many changes in economic policy. The book explores Koizumi's economic reform, new developments in Japanese people's socioeconomic conditions, the politics and economy after Koizumi, and the economic and political challenges facing Japan in the new century.

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THE WORLD
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Preface

The beginning of the new century witnessed a major turning point in Japan's economic and political performance and institutional design. Starting from a flawed financial liberalization process in the 1980s and the collapse of equity and land prices in the early 1990s, followed by a decade of economic and political distress in the 1990s, Japan started a transition toward more aggressive market reforms after Prime Minister Junichiro Koizumi came to power in 2001. By 2005, there were signs that the Japanese economy and financial system had finally commenced a sustainable recovery. Japan's economic and political institutions have also undergone significant redesign.

The book is part of a new series of books by Cambridge University Press and focuses on Japan's economic, political, and social development since 1980; hence, the title of this book – *Japan Since 1980*. Clearly the date of 1980 is somewhat arbitrary, especially when applied to more than one country. Nonetheless, important institutional changes took place in many developed and developing countries in the past three decades, with 1980 as a loose pivotal year. This is certainly the case for Japan.

It was not an easy task to provide an overview of Japan's economic and political performance and institutional development over the past three decades. At a minimum, it required the collaboration of an economist and political scientist to tell the story properly. Our collaboration on this book essentially started when Cargill and Sakamoto met and participated in a conference at Southern Methodist University in 2004. The collaboration has been successful; each has learned from the other, and the book reflects a political-economy perspective of Japan's development since 1980. The story also had to be told in such a way so as not to get bogged down in detailed discussion of economic and political institutions and events that would be of interest only to the specialist. We have made every effort to present the story in as clear a manner as possible so that the reader can obtain an overview of Japan's economic and political development during the past three decades.

The book is not merely a narrative of events but adopts a framework and point of view consistent with a wide range of research published in the specialist literature in economics and political science. Many examples of this research are cited in the book. We also made abundant use of information provided by Japanese newspapers and government ministries and agencies. The new institutional design of Japan's economy and political system is emerging, and Japan appears to have turned the corner on the severest of the economic distress of the past.

However, Japan continues to face serious economic and political challenges – the demographic challenges from a declining and aging population, the need to make the economy efficient and productive to survive and prosper in today's globalized economy, and the need to enhance the government's policy-making capabilities to generate policy innovations necessary to meet these demographic and economic challenges. The challenges are indeed formidable; however, we are cautiously optimistic that Japan will meet the new challenges with relative success. Although its path will not lead it to a Western set of economic and political institutions, Japan will continue to become more open economically and politically. Japan will remain one of the most important countries in the world for some time to come.

Cargill would like to thank students at the University of Nevada, Reno (UNR), his home institution, and the University of Hawaii at Manoa where he has been fortunate to teach during the summer for a number of years. Much of the material in this book was used in these courses. In fall 2007 at UNR, much of the manuscript was used in a class on Japan. He expresses appreciation to Susanna Powers, his graduate assistant, for reading the entire manuscript, preparing the index and for other contributions and, finally, expresses appreciation to Mary Cargill for her support.

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Both of us would like to thank our editor, Scott Parris, for his encouragement and guidance in preparing the manuscript. We appreciate the reviews of the initial proposal and, especially, the two detailed reviews of the draft manuscript. The reviewers made a large number of suggestions that significantly improved the book. Of course, we are responsible for any errors.

Abbreviations

BIS	Bank for International Settlements
BOJ	Bank of Japan
CEFP	Council on Economic and Fiscal Policy
CGP	Clean Government Party (also *Komeito*)
DIC	Deposit Insurance Corporation
DP	Democratic Party of Japan (formally DPJ in English)
DSP	Democratic Socialist Party
FDIC	Federal Deposit Insurance Corporation
FILP	Fiscal Investment and Loan Program
FSA	Financial Services Agency
GDP	Gross Domestic Product
HGP	High Growth Period
IMF	International Monetary Fund
JCP	Japanese Communist Party
JNP	Japan New Party
JSP	Japan Socialist Party (same as SDP)
LDP	Liberal Democratic Party
LP	Liberal Party
MITI	Ministry of International Trade and Industry
MMD	multimember district (an electoral system)
MOF	Ministry of Finance
NFP	New Frontier Party
OECD	Organization for Economic Cooperation and Development

PCA	Prompt Corrective Action
PR	proportional representation (an electoral system)
PSS	Postal Savings System
QEP	Quantitative Easing Policy
SDP	Social Democratic Party of Japan (formally SDPJ in English, the same as JSP)
SMD	single-member district (an electoral system)
ZIRP	Zero-Interest-Rate Policy

1

Introduction and Overview

Introduction

The evolution and transition of Japan's economic and political institutions during the entire post–World War II period is remarkable for two reasons. First, Japan completed reindustrialization and reestablished prewar economic growth trends in record time. By the 1970s, Japan emerged as the second largest economy in the world. Japan remains a major component of the world economy with one of the world's higher standards of living for its population.[1] Second, following the completion of reindustrialization, Japan's economic and political development exhibited wide fluctuations in performance. After a short but turbulent period of economic distress in the early 1970s, Japan achieved impressive economic, financial, and political stability from 1975 to 1989. The perception of Japan's economic invincibility became widespread during this period. Starting in 1990, however, Japan experienced intense economic, financial, and political distress. The economy and financial system continued to decline or stagnate until 2005. Despite economic recovery by the mid-2000s, Japan continues to face lingering economic and political problems.

[1] World Bank estimates of GDP, gross national income, and population can be found at http://www.worldbank.org, Quick Reference Tables. World Bank GDP rankings for 2006 in terms of Purchasing Power Parity (PPP) indicate that Japan is now the fourth largest economy in the world after the United States, China, and India. The 2006 data show Japan only slightly smaller than India but significantly smaller than the United States or China. PPP takes into account differences in price levels between countries so that an international dollar has the same purchasing power over GDP as a U.S. dollar has over GDP in the United States. In terms of 2006 real GDP adjusted for market exchange rates, Japan remains the second largest economy in the world.

The record of Japan's economic performance since the early 1970s and how Japan has adapted to internal and external forces of change have offered a number of important insights into the development process in general.[2] Japan has become a major case study and has influenced economic and political institutions in many countries as they either tried to emulate Japan's economic success or learn from Japan's failures.

The general outline of Japan's postwar development can best be understood by dividing the postwar period into four distinct periods. The first period, from 1945 to 1950, is one of *establishing economic stability.* During this period, Japan focused on stabilizing its economic and political institutions following the end of World War II. Serious efforts to stabilize the economy commenced in 1949 with the Dodge Line austerity program designed to reduce inflation, balance the budget, redesign the Bank of Japan (BOJ) to render it less susceptible to pressure to expand the money supply, and establish a fixed-exchange rate at ¥360 to $1.00. The second period, from 1950 to 1970, is one of *reindustrialization* and *relative political stabilization.* Japan achieved reindustrialization in record time because of the combined effect of the Dodge Line policies, the stimulative impact of the Korean War starting in June 1950, and the process of political stabilization starting in 1955 when the Liberal Democratic Party (LDP) assumed power. The period from 1950 to 1970 is frequently referred to as the High Growth Period (HGP) because annual real GDP growth averaged about 10 percent[3] with moderate inflation of about 5 percent. This is a relatively low inflation rate for such a rapid pace of real output growth. The third period, from 1970 to 1980, is one of *new environment* during which

[2] There is an immense literature on Japan's pre- and postwar economic development, some of which will be cited in subsequent chapters; however, a general overview of economic development through the late 1980s is provided by Ito (1992) and Yamamura and Yasuba (1987). Hoshi and Patrick (2000) provide a number of perspectives on the "lost decade" of the 1990s. Cargill, Hutchison, and Ito (1997 and 2000) review Japan's postwar financial and monetary development.

[3] Some observers regard 1955 rather than 1950 as the start of the HGP because the size of the economy did not achieve the prewar peak until about 1955. The starting year of 1950 used in this discussion is based on three considerations; first, the Dodge Line established a "takeoff" position for the Japanese economy; second, the start of the Korean War in June 1950 significantly stimulated the Japanese economy as Japan was used as a base of operations by the United States and allies; and, third, real GNP started rapid growth after 1949 (Ito, 1992, pp. 44–45). According to data cited in Ito (1992, p. 45), the average growth of real GDP from 1953 to 1970 was approximately 9.4 percent.

Japan's economic institutions came into conflict with a new set of economic, political, and technological forces. These forces set into motion a transition toward a "new" Japan that differs from the "old" Japan. The fourth period, starting around 1980, is one of *transition* toward a more market-directed economy and transition in the political regime. The transition continues to the present and is the subject of this study.

The wide swings in economic and political performance render the fourth period remarkable. In the 1980s, Japan seemed invincible in terms of economic, financial, and political stability, whereas in the 1990s and the beginning of the new century, Japan seemed unable to do anything right. The distress by the late 1990s illustrated to all but a few that the "old" Japan was no longer viable. Japan needed to adapt its economic and political institutions to a new environment and, in the process, the old social contract between the government and the population began to unravel.

These four periods – economic stabilization, reindustrialization and relative political stability, new environment, and transition – are pedagogical perspectives to conceptualize the main shifts and time periods of Japan's economic and political performance since the end of World War II. The starting and ending points are not precise, but they are close enough to identify the major shifts in economic, financial, and political institutions in Japan. The transition period is the most significant because it represents a dramatic shift in how Japan operates. The first three periods are collectively referred to as the pretransition stages of postwar Japan.

The pretransition stages of postwar Japan have been discussed extensively from both an economic and political perspective; however, it is important to summarize the highlights of the events leading up to the fourth period – the transition of Japan since 1980. The following is a brief summary of postwar Japan up to 1980.

The Pretransition Period: Developments up to 1980

Many of Japan's economic and political institutions in the postwar period up to 1980 continued to develop along trends established in the prewar period. The trends, however, were modified by the war experience and the Allied Occupation of Japan that lasted from 1945 to 1952.

Establishing Stability, 1945–1950

The immediate objective of the postwar government was to shift from wartime to peacetime production, absorb large numbers of returning military, and stabilize an economy marked by hyperinflation, unemployment, and government deficits. Japan's economic stabilization policies commenced under the guidance of a competent and strong bureaucracy. Economic and financial instability was addressed in 1949 by a series of polices collectively referred to as the Dodge Line, named after Joseph Dodge, who served as economic advisor to the Allied Occupation. The Dodge Line austerity policies would have generated significant economic cost in Japan in the short run; however, the start of the Korean War in June 1950 stimulated the Japanese economy so that Japan was able to establish a "takeoff" platform for reindustrialization and avoid the recession that normally would be expected from implementing the Dodge Line policies.

Democratization and the establishment of a new and stable government was the primary political objective of this period. Japan became fully democratic with free elections, free party competition, and universal suffrage after the new constitution came into effect in 1947. The constitution deprived the emperor of political power, and he became a symbol of state. Japan also was demilitarized completely.

Reindustrialization and Political Stabilization, 1950–1970

By 1950, the economy stabilized. The next two decades would witness a reindustrialization process in record time, accompanied by economic and political stability. This performance was achieved with a set of economic and political institutions that in many respects were a continuation of prewar trends. The bureaucracy was an important influence over the economy. The politicians would set a broad, general course for the nation, whereas bureaucrats crafted and implemented the economic policy to achieve the goal of economic recovery and growth. Japan developed a set of economic institutions designed to limit risk and bankruptcy through mutual support systems, nontransparency, long-term "customer relationships" rather than short-term "market-relationships," and relied on mercantilist trade policy. These clearly were a continuation of trends established in the prewar period.

Figures 1.1–1.5 provide an overview of Japan's economic performance for a major part of the postwar in terms of real and nominal

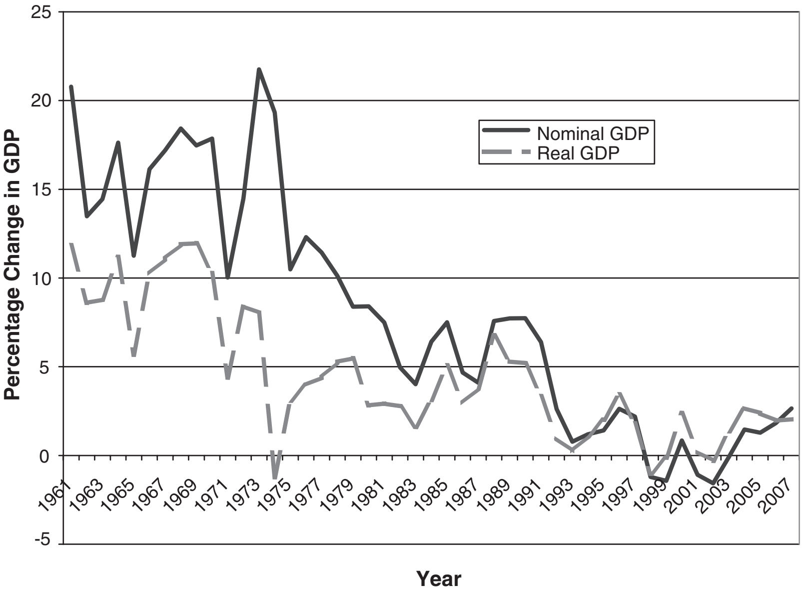

Figure 1.1. Annual Percentage Changes in Nominal and Real GDP, 1961 to 2007. *Source:* The OECD *Economic Outlook* (various years). *Note:* The values for 2006–07 are projections.

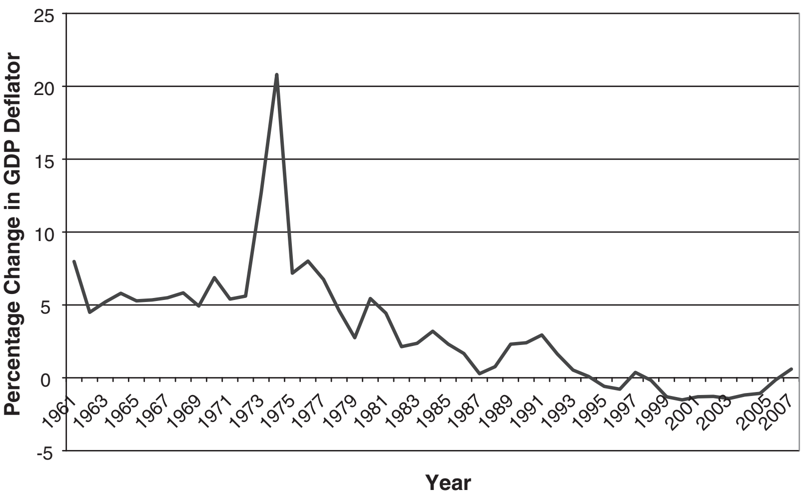

Figure 1.2. Annual Percentage Changes in GDP Deflator, 1961 to 2007. *Source:* The OECD *Economic Outlook* (various years). *Note:* The values for 2006–07 are projections.

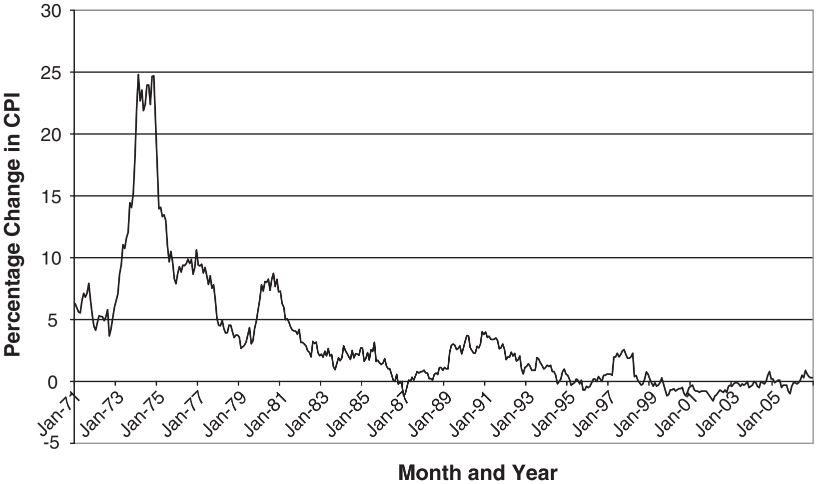

Figure 1.3. Annual Percentage Changes in the CPI from Year Ago, January 1971 to December 2006. *Source:* Ministry of Internal Affairs and Communications, Statistics Bureau, Consumer Price Index, http://www.stat.go.jp/english/data/cpi/index.htm.

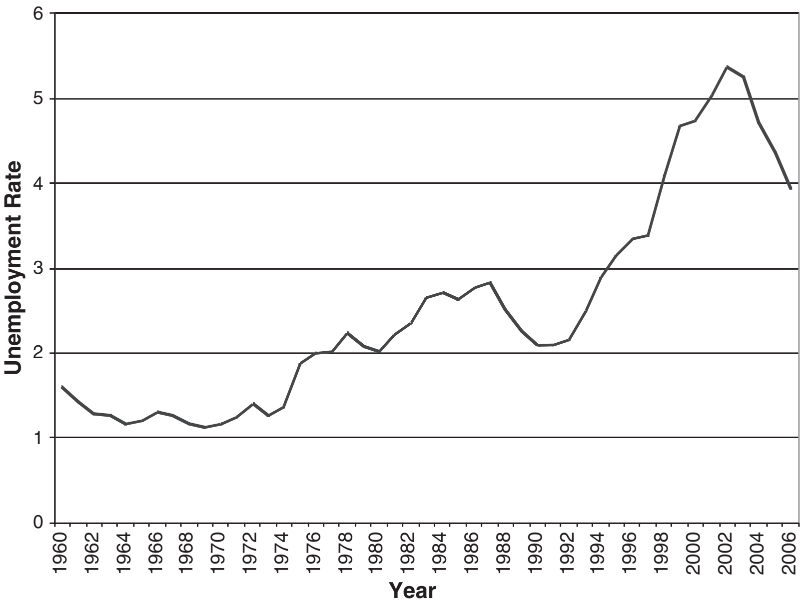

Figure 1.4. Unemployment Rate, 1960 to 2007. *Source:* The OECD *Economic Outlook* (various years). *Note:* The values for 2006–07 are projections.

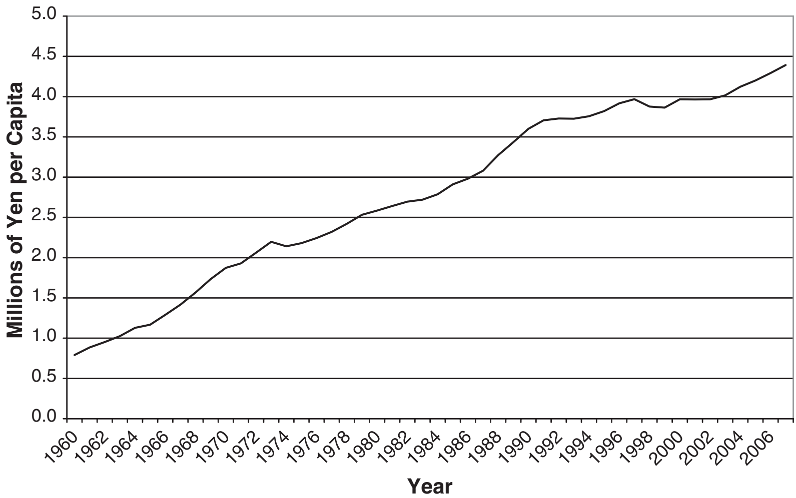

Figure 1.5. Real GDP per Capita, 1960 to 2007. *Source:* 1960–1979: GDP from Figure 1.1 and population from Ministry of Internal Affairs and Communications, Historical Statistics of Japan, Population; http://www.stat.go.jp/english/data/chouki/02.htm; 1980–2007: International Monetary Fund, World Economic Outlook Database, Japan, http://www.imf.org/external/pubs/ft/weo/2007/01/data/index.aspx. *Note:* The values for 2006–2007 are estimates.

GDP growth, GDP deflator and CPI inflation, unemployment rate and standard of living measured by real GDP per capita. The macroeconomic performance, the rise in the standard of living, and the relative political stability exhibited by the 1960s vindicated Japan's approach. The political system started its transition to a stable system in 1955, when two conservative parties merged to form the LDP, and the left and right wings of socialist parties merged to become the Japan Socialist Party (JSP). The new party system built around the two parties formed the basis of the so-called 1955-System, which lasted until 1993. In the 1955-System, the LDP controlled the Japanese government without interruption, with the JSP as the distant second largest party. Other small center-left opposition parties usually allied themselves with the JSP[4] in the earlier periods; however, from the end of the 1970s to 1993, they cooperated with the LDP more frequently.

4 The JSP later changed its name to the Social Democratic Party of Japan (SDP); hence, JSP is appropriate when referring to its origin while SDP is appropriate for references to later periods.

The general contours of Japan's industrial goals and approaches to achieving those goals did not experience wide shifts during the HGP, because of the LDP's one-party rule, the absence of political divisions affecting policy, and stable management by a bureaucracy staffed with permanent officials. In many ways, the industrial goals were a continuation of prewar objectives of first catching up with Western countries in economic development and then achieving superiority with Western countries, minus the goal of achieving military superiority to the West. This industrial objective had first been adopted around the time of the Meiji Restoration in 1868, when the country realized that it lagged far behind the West in industrialization and militarization after two and a half centuries of isolationist policy by the Edo government, which had ruled Japan between 1603 and 1867 (Tokugawa Period).

New Environment, 1970–1980

Three events impacted Japan in the 1970s that would induce and influence Japan's transition after 1980. First, the economic stability of the previous two decades ended with a short but turbulent period in the early 1970s of high inflation, referred to as "wild inflation." An unprecedented oil price shock in 1973, combined with several previous years of expansionary monetary policy, drove up inflation rates on a monthly basis to 30 percent per annum, adversely affecting economic growth. Japan weathered the oil shock reasonably well, and by 1975 the economy stabilized; however, the 1973 oil shock and another oil crisis in 1979 lowered Japan's natural growth path.

Second, Japan's reindustrialization process was completed by the late 1960s. The resulting decline in the rate of domestic investment spending, combined with higher energy prices, reduced the 10 percent growth rate of the HGP to the 3 to 5 percent range. Slower growth would have important impacts on Japan. Slower growth initiated financial liberalization, reduced revenue growth and contributed to government deficits, and began to alter the implicit social contract between the government and Japanese households. Japanese households had been willing to forgo access to the financial system as a source of funds (consumer and mortgage credit), place their substantial savings in government controlled low-interest financial assets, and support a producer-oriented public policy in exchange for high rates of real income growth and economic security. Although households continued to have faith that the government would guarantee economic security, the slower growth environment began to weaken a major pillar of the social contract that emerged after World War II – high and secure economic growth.

Third, Japan found itself in a new operating environment as the world started experiencing new economic, political, and technological developments in the 1970s. In varying degrees, these developments induced liberalization or "neoliberal" policies in a wide range of developed and developing economies.

The new economic environment was characterized by higher energy prices, uncertain supplies of energy, high and uncertain inflation rates, collapse of the fixed exchange rate system in 1973, and financial disruptions caused by government efforts to impose interest rate controls and other limits on the flow of funds. The new economic environment set into motion a financial liberalization process that eventually would affect most of Japan's economic and political institutions because it clashed with Japan's rigidly controlled, internationally isolated, and regulated economic and financial system.

The new political environment was characterized by a general shift in attitudes in industrial democracies away from collectivist approaches to managing the economy such as that adopted by Japan toward market-directed resource allocation systems as in the United States. This in no way is meant to imply that the United States was a model of individualism, but of all of the major industrialized economies during this time, the United States relied less on collectivist approaches to managing the economy than any major country. The collectivist approach had been found wanting in many places by the 1980s and, as a result, a new political attitude emerged that emphasized open and transparent markets, less government interference, and more open and democratic political institutions. The pace and extent of liberalization varied from country to country and the process was more often driven by market innovations rather than government innovations. In fact, it was market innovations especially in the financial sector that forced governments to change regulations. The process was well under way in the United States by the 1970s and reinforced by the election of President Ronald Reagan in 1980. Margaret Thatcher's election as prime minister in 1979 was a turning point in the United Kingdom. Japan was not immune. Japan experienced increasing demands from the United States, the United Kingdom, and Europe to cease its mercantilist policies, open its real and financial sectors to the rest of the world, and in general adopt a more market-oriented set of economic institutions.

The new technological environment was characterized by advances in computer and telecommunication technology, making it increasingly difficult for governments to impose binding constraints over the financial system or to regulate the inflow and outflow of capital. The international financial system was becoming increasingly flexible, and the collapse of the fixed exchange rate system made it difficult for export-oriented countries such as Japan to remain isolated from the international financial system.

The new economic, political, and technological environment, combined with slower long-run growth potential, set the stage for the transition of Japan's economic and political institutions, which continues to the present day. The transition after 1980 started with limited financial liberalization, which appeared successful in the 1980s. Flaws in the process, combined with policy errors by the BOJ and the Ministry of Finance (MOF), brought Japan to an abyss of deflation, recession, and the insolvency of its banking system in the late 1990s. As a result, the nature and extent of the transition changed dramatically.

The Transition since 1980 in Broad Perspective

The past three decades have witnessed major changes in Japan's economic and political institutions. Although Japan has and will continue to develop its own model of the market and democracy conditioned by its culture, history, and perception of its place in the world, the newly evolving economic and political institutions will continue to become more open, competitive, transparent, and responsive to a different set of socioeconomic interests than in the past. The ongoing transition has and will affect the social contract between the government and its citizens.

The transition in broad perspective can be considered in terms of four periods defined by Japan's economic and financial performance, response of the government to the new operating environment, policy outcomes of that response, and the extent to which Japan's economic and political institutions changed. The transition is decomposed into phases defined both in terms of time sequence and policy outcomes.

The High-Water Mark of Japanese Economy, 1980–1985

The designation of this period as the "high-water" mark of the transition is a result of the apparent success that Japan achieved in adapting to the new environment and achieving a high degree of economic and political stability in sharp contrast to other countries' experiences. Much of the world came to admire Japan's economic and political institutions because Japan seemed to have achieved economic, financial, and political stability, whereas many industrialized economies were dealing with high rates of inflation, unemployment, and financial disruptions.

The period started with Japan avoiding the inflation-disinflation process typical of virtually every industrial economy in response to the second set of oil price shocks in 1979–1980. The typical response in most countries was to inflate the economy by central bank policy to offset the adverse effects of higher prices on real GDP. This policy was based on the traditional Phillips curve long-run trade-off between inflation and employment in which higher employment could be purchased with higher inflation. The Phillips curve policy was fundamentally flawed, however. The attempt by central banks in other industrial economies to offset the recessionary pressures of the oil crisis and maintain employment failed, and the high inflation required central banks subsequently to disinflate the economy, which intensified the economic distress. These countries ended up with "stagflation" – higher inflation and lower employment (higher unemployment). Japan not only avoided stagflation and its associated economic disruptions, but, more remarkably, the BOJ continued to follow a price stabilization policy while at the same time being one of the world's most formally dependent central banks. This performance earned the BOJ the reputation as a "model central bank" in terms of price stabilization policy outcomes and its credibility as a price-stabilizing central bank. This performance and reputation contradicted the conventional wisdom that formally dependent central banks were more likely to generate inflation than formally independent central banks such as the Federal Reserve System.

It was not just Japan's economic policy success that drew world attention. Japan also appeared to be engaged in a successful financial liberalization process on both the domestic and international front. Long recognized as critical to the functioning of the entire economy, the financial system was designed to transfer the large savings of the household sector to the corporate sector. The Japanese financial system that reached maturity in the 1970s was rigidly regulated, administratively controlled, internationally isolated, and relied on the transfer of funds through private and public bank channels, as opposed to relying on money and capital markets. In fact, corporate governance was intimately tied to the financial system relying on a set of company groups or *keiretsu*, centered on a large financial institution, usually one of the large city banks. This system also was known as the main bank system.

Japan's transition starting in the second half of the 1970s focused almost entirely on the financial system[5] by permitting financial institutions to become more market-oriented in how they evaluated credit, monitored credit, and priced credit; by commencing a policy of interest rate liberalization; by relaxing constraints on the inflow and outflow of capital; by permitting money and capital market to develop; and by permitting greater access to the domestic financial system by foreign financial institutions. The pace of reform was slow and incremental but, by the early 1980s, Japanese financial markets and institutions were more competitive, more diversified, and more open to international competition than previously.

Japan's financial transition outcomes stood in sharp contrast to the experiences of other countries, especially the United States and parts of Europe. These countries were dealing with high rates of inflation and unemployment, and financial disruptions ranging from banking problems in a large number of countries to the collapse of the savings and loan industry in the United States. Japan had not only become the second largest economy in the world and appeared to be a "model of financial liberalization" with a "model central bank" that maintained price stability but also emerged as a major financial power in the world by the mid-1980s. In 1985, Japan became the largest creditor nation in the world, Japanese banks were the largest in the world, and Japanese financial institutions appeared sound and stable.

[5] The financial reforms started in 1976 increased in pace so that by the early 1980s, Japan was officially committed to liberalizing its financial system, including allowing foreign financial institutions to play a meaningful role in the allocation of credit. In 1976, the MOF officially recognized a short-term market in repurchase agreements based on government bonds (*gensaki* market) and in 1978 permitted banks to issue large certificates of deposits (CDs). The MOF made a series of administrative decisions starting in 1978 that relaxed controls over the government bond market and permitted secondary markets in government bonds to be established.

Japan's financial liberalization process was impressive, considering the starting point; however, the reforms paled in comparison to the changes needed to render Japan's financial system open, competitive, and transparent. As a result, developed countries continued to pressure Japan to increase the pace and extent of financial liberalization and extend liberalization to the nonfinancial sectors of the economy by eliminating trade barriers, restructuring corporate governance, and reforming labor markets. In hindsight, the apparent stability of the financial transition was misleading for two reasons.

First, the transition toward more open and competitive institutions was confined to specific and narrow components of the financial system. Nor did policy makers comprehend the far-ranging effects on economic and political institutions that even limited financial liberalization would generate. Increased emphasis on financial innovation, competition, and greater presence of foreign financial institutions would require a changed view of Japan's labor practices of "lifetime" employment and the seniority-based wage system. The entrance of foreign financial institutions and new financial services and assets would require higher labor productivity and incentives to innovate not constrained by lifetime employment or seniority wages.

Second, financial liberalization policy was fundamentally flawed and masked growing conflicts that made the financial system and general economy susceptible to any shock. In this regard, the successful price stabilization policy of the BOJ played an important role. Price stability narrowed the gap between regulated and unregulated interest rates and, hence, made it easier for Japan to pursue a slow and gradual financial liberalization process that essentially left the old regime in place and limited any manifestation of the growing conflicts. In addition, the BOJ's policy successes contributed to overconfidence in the ability of monetary policy to achieve economic stabilization that increased the probability of policy error.

An Accident Waiting to Happen, 1985–1990

The end of the "high-water" period began in 1985 at the very height of Japanese economic and political stability, when the BOJ, with the support of the MOF, conducted a monetary policy focused on external rather than internal conditions. This policy was designed to redress trade imbalance between the United States and Japan agreed to by the Group of Five (G5), known as the September 1985 Plaza Accord.[6] The policy first focused on depreciating the dollar (appreciating the yen) to reduce the large U.S. current account deficit. But because the dollar started to decline more rapidly than desired, the BOJ shifted to an expansionary monetary policy to defend the dollar and stem yen appreciation. The easy monetary policy also was rationalized as a countercyclical response to Japan's recession induced by the rapid yen appreciation and its negative effects on exports. The government was not willing to use fiscal policy (increased spending) for economic stimulus because it had been pursuing fiscal austerity since 1980 to reduce the budget deficit. As a result, the Japanese government placed the burden of economic stimulus on the BOJ's monetary policy. Money and credit expanded after 1985.

Although the second half of the 1980s appeared to be a continuation of the first half in terms of macroeconomic performance and continued financial liberalization, the shift toward expansionary monetary policy after 1985 combined with a flawed financial liberalization process led to the "bubble" in equity and real estate prices. Equity and real estate prices by 1988 exhibited all of the characteristics of an unsustainable asset bubble. The flawed financial liberalization process, combined with a set of political institutions wedded to the old regime, turned Japan into an "accident waiting to happen." Any shock to the system would generate economic and financial distress. The collapse of asset prices in 1990 and 1991 provided the shock.

The "burst of the bubble economy" commenced in 1989 when the BOJ raised the discount rate in May 1989 over concern about asset price inflation and an increase in the general inflation rate. The immediate effect was to slow asset inflation and economic growth. But by 1990 and 1991, asset prices collapsed, and subsequent events revealed a fundamentally weak financial system and set the stage for a long period of intense economic distress. It is common to refer to Japan's economic performance during the 1990s as Japan's "lost decade"; however, since the economic distress continued into the new century, it might be just as appropriate to refer to Japan's economic stagnation over the 1990–2005 period as Japan's "lost decade and half."

[6] The Plaza Accord was signed September 22, 1985, at the Plaza Hotel in New York City by the G5 – France, West Germany, Japan, the United States, and the United Kingdom. The decision was made to coordinate exchange market interventions to depreciate the dollar against the yen and the German mark.

Japan's economic bureaucracy and politicians were wedded to the old regime of mutual support and nontransparency and, at the same time, maintained high confidence in their ability to manage the economy. Policies that emerged from this condition failed to reverse the economic and financial distress, which ultimately led to a redesign of Japan's economic and political institutions.

Economic, Financial, and Political Distress, 1990 to 2001

The 1990s begin with the collapses of asset prices, disinflation, and recession. At the start, policy makers and the public were not particularly concerned. In the past, Japan's recessions were relatively short and not severe. Inflation had been contained successfully since 1975. Although misconceived, the asset bubble had increased the wealth of a large number of households. The public remained passive and continued to have faith that Japan's economy would prosper, and continued to anticipate an increase in the standard of living in a relatively risk-free socioeconomic environment. In sum, the slowdown after 1989 was viewed as only temporary by both the public and the government. Japan would again regain the momentum of the 1980s under the current political-economic regime.

This attitude changed as the decade progressed. Economic and financial distress continued and intensified after a brief recovery in 1995–1996. The near collapse of the economy in 1998 and major solvency problems in the financial system forced Japan to acknowledge that the set of economic and political institutions that had served Japan since the end of World War II were incompatible with the new environment and, hence, had to be changed. Public perceptions of how the Japanese economy worked and public expectations of their future standard of living changed radically near the end of the 1990s. Continued economic and financial distress dashed the public's confidence in their economic security based on low unemployment and lifetime employment. The failure of government to end the crisis dashed the public's confidence in the ability of the government to manage the economy. A series of corruption scandals involving the MOF and the BOJ further shook the public's confidence in the economic bureaucracy. The public also started to lose trust in the social security pensions and health care systems provided by either the government or their employers, because of their rising costs as a result of the significant aging of the population – the public expected increased future contributions and premiums and reduced benefits.

The economic and financial distress reversed a record of four decades of stability, growth, and development. Japan's economy exhibited either negative or very low positive growth in the 1990s. Starting in late 1997 and throughout 1998, Japan came close to collapse. Prices started falling in 1995, and deflation continued to at least 2007. The unemployment rate increased. Unemployment doubled to around 5 percent compared to the pre-1990 period. The 1990s is referred to as Japan's "lost decade" because of the lost economic and financial development potential. The economic and financial distress was matched by great political instability.

Japanese politics under LDP rule had remained relatively static from the mid-1950s to the late 1980s. But in the late 1980s, Japanese politics and policy making started undergoing changes that were gradual but altered the nature of the postwar economic-political regime. In 1989, the LDP lost its majority in the upper house election for the first time since 1955. More important, the LDP lost control of government in 1993 for the first time in its history when it lost its majority in the lower house election. Just before the 1993 election, two groups of LDP politicians left the party to form two new conservative parties, and, as a result, the LDP was unable to win the majority in the lower house. The LDP was replaced by a non-LDP eight-party coalition government. From the early 1990s on, political parties split, merged, or were created on a large scale. Many politicians switched party affiliation in efforts to ensure their reelection and improve the prospects of being in a party that could win control of government. In this environment, it almost appeared that responding to the economic crisis was secondary in politicians' priorities, as they were preoccupied with their own political survival. The LDP returned to power in 1994, but because of decline of the LDP's electoral strength, the Japanese government has since been ruled by coalition governments most of the time.

Important electoral reform took place in 1994. The multimember district system (MMD) was replaced with a mixed member system combining single-member districts (SMD) and proportional representation (PR). This reform initiated large-scale party realignment and changed the structure of party competition. Electoral reform also changed the power relationship between party leadership and member politicians. Previously, the intraparty factions in the LDP retained significant power vis-à-vis party leadership, including the party president (prime minister) because the factions controlled the LDP presidential election, post assignments, individual candidate nomination and endorsement, and financial resources. Electoral reform indirectly redistributed power from the factions to party leadership by introducing a new party subsidy system in which government subsidies were given to political parties that were controlled by party leadership. This power shift became conspicuous under the Koizumi administration (2001–2006), when Junichiro Koizumi significantly reduced the power of the factions by depriving them of their power of cabinet post assignments and policy-making control.

Another political change induced partly by electoral reform took place after Koizumi came to power, when policy competition came to play a larger role in intra-LDP competition as well as in interparty competition. The role of public opinion became increasingly important in policy competition within the LDP and across political parties, because the new electoral system made politicians more sensitive to public opinion, as will be explained in Chapter 7. Political parties started judging the legitimacy of different policies by the public support that they enjoyed. Public opinion likewise came to constrain the power of the bureaucracy, because public support became important in policy making and implementation and politicians came to pay more attention to public opinion.

Koizumi – The Unconventional Politician, April 2001–September 2006

The public wanted change by the end of the 1990s, and time was ripe for the emergence of strong and effective leadership that could make policy outside the box of the LDP's conventional distributive politics. Prime Minister Koizumi's succession of power could not have come at a more opportune time. Koizumi was elected prime minister by the LDP in April 2001 after a campaign against former Prime Minister Hashimoto, a traditional LDP leader. Koizumi ended his tenure as prime minister at the end of September 2006. During this period, Japan was to experience significant changes in politics and the economy.

Koizumi was considered unconventional. First, although he was an LDP politician, he set out to destroy what he called the "old" LDP that was at the center of Japan's interest-based iron triangle of