The Crisis of Over-Accumulation in Japan

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ABSTRACT  Japan has now been mired in economic stagnation, punctuated by recurrent recessions, for the past two decades. What are the causes of this longstanding malaise? Is it merely the natural consequence of financial retrenchment and the onset of a pervasive “liquidity trap” after the collapse of the “bubble” economy in the early 1990s, or does the present slump signify a more profound historical phase of structural decline? The aim of this study is to provide several tentative hypotheses. In the first section, some of the possible causes of this phase of prolonged stagnation will be examined. The next section provides a theoretical treatment of the dynamics of debt-deflation from a Minsky-Fisher perspective. The final section evaluates whether the historical evidence lends credence to the debt-deflation thesis.

KEY WORDS: Over-accumulation, excess-capacity, debt-deflation, finance, labour

Japan’s descent into a prolonged period of economic stagnation over the past two decades has provoked perennial debates over the causes and dynamics of this phase of secular stagnation. The aim of this article is to examine the persistence of Japan’s mediocre economic performance from a Fisher-Minsky perspective. In other words, to what extent is it possible to characterise this stagnationist phase in terms of the debt-deflation theory of depressions. A similar analysis has been recently articulated by Richard Koo (2008) in which he describes Japan’s longstanding malaise as a “balance sheet recession” driven by the large Japanese corporations (keiretsu) and the banks as they pursue a strategy of deleveraging in order to restore their respective balance sheets from the accumulated debt incurred during the previous “bubble economy” of the 1980s. Authors such as Krugman emphasise Japan’s pervasive liquidity trap as the major cause of Japan’s stagnation, which is quite consistent with the Minsky-Fisher thesis of debt-deflation. This article will examine the evidence, which supports these theories and also provides a historical perspective to argue that there is a structural and institutional dimension to the secular crisis related to Japan’s post-war export-led developmental model governed by what Chalmers Johnson (1982) describes as the “plan-rational state.” Japan’s post-war neo-mercantilist model of development appears to have reached its limits. It will be argued that Japan’s political elite have so far failed to engineer a structural transition away from an over-reliance on export-led growth and towards the domestic market as the major engine of growth. The international implications of Japan’s neo-mercantilism are also examined.

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The Rise and Fall of Japan’s Euphoric Bubble

Japan’s current economic malaise has its roots in the chain of events that led to the expansionary monetary policies enacted after the September 1985 Plaza Accords. These events originated with the new US economic strategy inaugurated by the Reagan administration in which a more orthodox monetarist strategy was adopted to resolve the incessant problem of stagflation. The essential aim of the Volcker “shock” was to impose a highly restrictive set of monetary policies in order to dampen the inflationary forces generated by the second oil price shock in 1979. A strong dollar was therefore pursued by the Reagan administration, which was driven by a sharp upsurge in interest rates. The vertiginous rise in the US dollar, however, was not induced by a substantial improvement in the American trade deficit, or by a recovery of its industrial export competitiveness. Instead, the massive inflow of capital was governed almost entirely by the inducement of high nominal interest rates. In retrospect, the contradictory US strategy of tight monetary policies accompanied by expansionary fiscal policies, which were partly driven by increased military expenditure, could not be sustained as long as the US continued to accumulate a burgeoning balance of payments deficit.

The strong dollar policy in the first term of the Reagan administration generated two contradictory outcomes. Although the strong dollar and high nominal interest rates contributed to a curtailment of domestic inflation, it also had a negative impact on US export competitiveness, which was reflected in the deterioration of the balance of payments. The US trade deficit had increased from an average of US$27 billion in 1978–80 to US$148 billion in 1985, while the current account deficit had blown out from US$4 billion to about US$128 billion over the same period (Parboni 1986). By March 1985, the dollar was estimated to have appreciated by more than 30% on a trade-weighted average since the beginning of 1981. International pressure began to mount for a series of sustained dollar depreciations, especially after the realisation that the US economy had become a net debtor for the first time since the turn of the century. This was accompanied by a growing protectionist sentiment in the US Congress. The Reagan administration could either succumb to these protectionist demands or divert them through dollar depreciations. With the onset of a severe international recession in the early 1980s, caused to some extent by the highly restrictive, anti-inflationary policies enacted by most Organisation for Economic Co-operation and Development countries, the Reagan administration propounded the “locomotive theory” in which they attempted to persuade the major surplus countries of Japan and Germany to pump prime their economies, arguing that a concerted fiscal stimulus would redress the widening trade imbalances and generate a sustained recovery. Both the German and Japanese authorities, however, were quite reluctant to pursue more expansionary policies because of the inflationary risks involved.

In light of these events, a more interventionist policy emerged in contrast to the prevailing policy of “benign neglect” that had informed US exchange rate policies. With the breakdown of macroeconomic policy coordination between the major industrial countries (the Group of Five, or G5), the central bankers of these countries launched a series of concerted interventions in order to avert a crash landing of the US dollar. An estimated US$12 billion was mobilised in March 1985 to engineer a soft landing. Within a year, the dollar had depreciated by 35% on a trade-weighted average; the US dollar/German mark rate had fallen from 3.47 to 2.25 and its Japanese yen value from 260 to 175. After the Plaza Accords of September 1985, another concerted central bank
intervention was orchestrated to counter the cascading, speculative frenzy in global currency markets. The failure of Germany and Japan to stimulate their economies as the US had requested during the Plaza Summit only provoked US officials to “talk down” the dollar in what soon developed into a dangerous game of monetary brinkmanship (Funabashi 1988). Although this American strategy eventually persuaded the Japanese to pursue a more expansionary policy after the stock market crash of October 1987, the German authorities remained intransigent.

As the dollar rapidly fell from 1985 onwards, a vicious circle developed with the emergence of inter-state rivalries over markets and investment outlets (Parboni 1986). It was in this volatile environment that international summits were convened to engineer a “soft landing” of the US dollar and to coordinate macroeconomic policies. Given the high reliance of Japanese exports destined to the US market, the Japanese monetary authorities succumbed to US pressure and the Bank of Japan (BoJ) accommodated a dollar depreciation through quite substantial open market operations. But the sharp appreciation of the Japanese yen failed to restore the balance of payments equilibrium with the US. The period of endaka, or the skyrocketing increase in the value of the yen, soon began to undermine the profitability of Japan’s exports. Japanese investors incurred huge foreign exchange losses as a result of the depreciation of the US dollar from 240 yen in 1985 to 80 yen in 1995. By shifting a substantial proportion of their labour-intensive manufacturing offshore to the cheap labour zones of Southeast Asia, Japanese transnational corporations were, to some extent, able to temporarily restore their export competitiveness. In order to mitigate the effects of an appreciating yen, the Japanese government embarked upon a programme of monetary accommodation by reducing interest rates. Yet by pursuing relatively loose monetary policies, the government set in motion an unprecedented expansion of excess liquidity in the financial markets, most of which was channelled into what became known as zaitech operations, or speculative financial engineering (Yoshikawa 2001). As a result, a financial mania was triggered in the real estate and equity markets. The boom became self-fulfilling. As asset prices rose sharply, further borrowing only served to fuel the asset price spiral in a self-reinforcing dynamic. As Johnson quite succinctly argues:

The result of the US pursuing an exchange-rate approach to the problem of trade with Japan was profound. They made no difference to the trade imbalance, but they stimulated Japan to undertake countermeasures to the high yen, which led to Japan’s bubble economy, then to the collapse of the bubble economy, then to Japan’s export of its bubble economy to South East Asia, and finally to the economic meltdown that confronts us today (Johnson 1998, 656).

These events set in train the biggest build-up of excess liquidity in modern Japanese history. In 1989–90, the BoJ increased interest rates from 3.8% to 8.2%, which triggered the bursting of the financial bubble. Stock market prices tumbled by more than 60% from their peaks (Halevi and Lucarelli 2002). The Japanese economy was effectively caught in a liquidity trap from which it has yet to recover. At the very core of this problem was the lack of effective demand. The structural propensity to build up productive capacity while experiencing a concomitant and relative diminution of effective demand has led to a generalised crisis of over-accumulation. Indeed, the only components of effective demand
keeping the Japanese economy afloat are government spending and net exports. In the absence of a recovery of domestic consumption, both of these components will ultimately reach their economic and political limits.

The *keiretsu* that had invested in extra capacity to meet the demand caused by the 1980s boom soon found that they were burdened with massive excess capacity and escalating debt/equity ratios (Itoh 2000). Problems of excess capacity emerged since investment in fixed capital was dependent upon long-term rates of return, which could not be validated in the short term as borrowing costs rose quite precipitously. Under these circumstances, it was very difficult to reactivate the process of capital accumulation, even at very low rates of interest since the accumulated investment or the “sunk costs” in fixed capital tended to depreciate very slowly over a long period of time (Lucarelli 2011, 42).

Excess capacity and depressed profitability therefore set in train the dynamics of stagnation. By the late 1980s, most of the large *keiretsu* began to generate internal funds for investment and curtailed their traditional reliance on the BoJ and the big banks. In the early 1970s, the large oligopolies relied on about 40% of their loans from the big banks. By the late 1980s, after the deregulation and liberalisation of capital markets, this dependence had fallen to only 6% (Yoshikawa 2001, 57). Deprived of their traditional sources of investment, the banks began to engage in reckless speculation in real estate and the stock market. Japan’s financial institutions injected about US$220 billion in new loans to the property sector alone between 1985 and 1990 (Whittaker and Kurosawa 1998). A protracted phase of deleveraging was now set in motion as the corporate sector sought desperately to restore their respective balance sheets. By the mid-1990s most of the banking system was technically insolvent. “Zombie banks” were put on life-support through enormous state bailouts.

It can be argued, with considerable justification, that Japan had generated a speculative mania in the East Asian region after the collapse of its own asset price bubble in 1991. This claim can be supported by the fact that Japan’s commercial loans to the region had increased from only US$40 billion in 1984 to over US$265 billion in 1996 (Yoshikawa 2001, 9). The sharp fall in the volume of exports from East Asia just before the East Asian financial crisis had triggered a series of balance of payments deficits, which were financed by short-term capital inflows, predominantly from Japan. At the same time, the collapse of Japan’s speculative bubble led to a curtailment of their foreign direct investment (FDI) in the region from 1995 onwards. This process of retrenchment was also amplified by the sharp depreciation of the yen at about the same time. Between June 1995 and June 1997, Japanese claims in the Asian newly industrialised countries fell from US$301 billion to US$180 billion (Hughes 2000, 229). Hence, the crisis of over-accumulation in Japan was regionalised before the onset of the East Asian financial meltdown of 1997–98 (Lucarelli 2002). As soon as the East Asian countries encountered balance of payments deficits, spurred by problems of overcapacity, Japanese FDI was sharply curtailed and then acted as one of the catalysts for the ensuing currency crises in 1997–98.

By the early 1990s, the Japanese economy was engulfed in a debilitating crisis of over-accumulation. The rate of capacity utilisation in Japanese manufacturing in 1993 had declined by 17% from its peak of 1990, and it fell again after a tepid recovery in 1994. As Itoh (2000, 91) notes:

> Continuing excess capacity certainly depresses investment in plant and equipment… With huge excess productive capacity, Japanese firms sharpened their competitive
pressure in the market. Thus a vicious circle leading to a spiral of depression set in
the Japanese economy, comprising falling prices of shares and land, falls in workers’
income, and depressant prices in the markets for products and services.

To be sure, increases in productivity had outstripped wages growth by a large margin. The
lack of effective demand in the domestic market only further encouraged outflows of
capital, mostly destined to the East Asian region. By the early 1990s, East Asia had been
transformed into a formidable export zone. Whereas in 1985, East Asia (excluding China)
had only accounted for 12% of world exports, by 1993 this figure was 19% and reached
as high as 23% before the outbreak of the financial crisis in 1997 (Hatch and Yamamura
1996, 189). The high yen made Japanese wages simultaneously too high and too low. In
terms of costs, wages were too high to compete against East Asian exports and sustain
previous levels of manufacturing employment. From the standpoint of effective demand,
however, wages were too low to absorb the excess capacity. Consequently, Japanese
corporations accelerated their export strategies in order to resolve their problem of
domestic surplus capacity and counteract a falling profitability. The high yen after 1985
therefore had a perverse effect in that capital could appropriate higher profits through a
strategy of exporting capital to East Asia in order to export goods from these production
zones to Europe and the United States (US). The domestic market could not act as the
engine of growth as long as real wages lagged behind productivity growth in order to
increase the level of oligopolistic profitability. FDI provided low-cost production sites in
East Asia that enabled Japanese corporations to export to the high wage markets in Europe
and the US (Steven 1991, 59). In essence, Japan sought “to maintain its export-led growth
by ‘regionalizing’ it” (Gilpin 2000, 270).

A Minsky-Fisher Perspective

In order to shed some light on Japan’s phase of secular stagnation, a digression into the
Minsky-Fisher theory of debt-deflation might be useful. Minsky’s analysis is informed by
the view that a capitalist economy is characterised by two sets of relative prices: (i) current
output; and (ii) capital assets. On the one hand, prices of capital assets depend upon
expectations of future rates of return to capital and the Keynesian notion of liquidity
preferences. On the other hand, the prices of current output will be determined by existing
perceptions of short-term demand conditions: “Capital assets and current output prices are
based upon expectations over quite different time horizons: capital asset prices reflect
long-run expectations and current output prices reflect short-run expectations” (Minsky
1982, 95).

This implies that past investment must be justified by the stream of income received by
entrepreneurs which, in turn, must also be sufficient to cover payment commitments,
including debts incurred over time. Prices in excess of costs must generate cash flows
(profits, quasi-rents), which allow the enterprise to reinvest and validate past debts. To
quote Minsky: “For a capitalist system to function well, prices must carry profits”
(Minsky 1986, 142, emphasis in original). Current output prices are determined by the
level of effective demand and the “mark-up” of profits over costs. The prices of existing
capital assets depend upon supply and demand. But the existence of high “sunk” costs,
which characterise long-term investment in plant and equipment, means that the supply of
existing assets is fixed in the short term. The proximate determinants of demand for
capital assets, however, depend upon the expected profits and quasi-rents generated by existing assets and the expected degree of liquidity. Minsky’s analysis augments Keynes’s notion of uncertainty in the sense that future profit flows and the ability to increase liquidity by selling assets in the event of a fall in demand, cannot be readily planned in advance (Pollin 1997, 28). In Minsky’s own words: “Investment, its financing, and its validation are the keys to the performance of our economy. Investment affects the financial structure of the economy in two ways: projects need to be financed and investment activity generates corporate profits – the quasi-rents upon which the viability of private financial commitments depends” (Minsky 1986, 217–218).

During the phase of upswing in the economic cycle, financial institutions, driven by the profit motive, increasingly engage in the process of financial innovation. Either to overcome existing barriers to the expansion of credit-creation in the form of prevailing regulatory regimes, or to substitute money for other highly liquid assets, private financial institutions seek to expand lending to meet the rising demand for investment. Endogenous credit expansion tends to induce a rise in asset prices, which then increases the price for current investment. The causation is cumulative: a positive feedback loop soon emerges in which the demand for external finance stimulates further rounds of investment until the economy exceeds full capacity utilisation. “Financial innovation therefore tends to induce capital gains, increase investment, and increase profits: the economy will try to expand beyond any tranquil full-employment ‘state’” (Minsky 1986, 78). The economy therefore tends towards disequilibrium as these destabilising financial forces assume more speculative forms. Asset price inflation during the peak of the boom will generate an increase in investment and consumption through the various channels of income and cash flows. When the price of capital assets exceeds the price of current output, excess investment is channelled into rising equity markets, which also encourages investors to increase their leverage. An implicit capital gain is realised, which merely serves to attract more investment. In other words, the rise in the price of capital assets relative to the price of current output could set in train quite perverse wealth effects, which amplify increases in consumption and investment.

The margin between the price of capital assets and the supply price of investment (inclusive of financing costs), tends to vary inversely with interest rates. During a boom, the increasing propensity to borrow from capital markets has the overall effect of stimulating investment and profits and the willingness to be exposed to higher risk by engaging in the debt-financing of asset positions. In the course of the speculative boom, these financial units will become more vulnerable to a sudden upsurge in the rate of interest. This causes a diminution in the margin between the current value of assets and the price of investment output. If the price of capital assets falls below the supply price of investment as a result of rising interest rates, the previous margins of safety will be eliminated and the financing of investment will be curtailed. The effect is self-reinforcing: a fall in investment now has a reverse effect on the value of assets as investors attempt to sell out their positions in the equity markets. If the level of debt/equity ratio is historically high, the whole process leads to a credit crunch, which triggers further falls in asset prices. According to Minsky: “Such a sharp decline in asset prices is what occurs in stock market crashes. Downside instability of asset prices can lead to a spiral of declining investment, declining profits and declining asset prices” (Minsky 1986, 45).

The boom itself therefore generates endogenously destabilising forces, which spill over beyond full-employment equilibrium and induce a speculative boom. During the course of
the boom, the inbuilt “margins of safety,” to which both borrowers and lenders had agreed upon to insure against possible default, are gradually and progressively relaxed. These margins of safety also affect the degree to which investors are willing to resort to external finance in order to activate future investment. The rise in the relative external/internal financing ratio reflects the prevailing perceptions that the margins of safety required to finance investment are no longer necessary to protect against the possibility of default. As the risk for borrowers is eased, the demand price for capital assets increases. Conversely, the easing of perceived risk for lenders corresponds to a fall in the price of investment output (Minsky 1986, 188).

A fundamental property of all capitalist economies is the existence of a system of borrowing and lending based upon various margins of safety. The excess of anticipated cash flows from asset ownership or participation in income production over the cash flows committed by the liability structure is one class of margins of safety. The excess of the market or the pledge value of assets over the value of liabilities which can require the payment of some principle amount is another class of margins of safety (Minsky 1991, 12).

An investment boom has the effect of increasing the rate of external borrowing, which leads to a deterioration of the firm’s balance sheet. As asset prices continue to rise, hedge financing structures become more speculative and as the asset price euphoria peaks, the pyramid of debt leads to widespread and pervasive financial instability. The accumulation of debt therefore creates the paradoxical situation in which the validation of past debts can be financed by the issuing of new liabilities. In other words, the conditions for lending deteriorate as the financial euphoria gives rise to the easy availability of credit (Toporowski 2005, 144). Minsky’s hypothesis rests on the evolution of liability structures, which in the aftermath of an asset price boom can no longer be validated by current cash flows as asset market values fall quite precipitously. After a sustained boom, the financial structure of an economy might become vulnerable to only small increases in the rate of interest because of the shift from the expected hedge position to a speculative position, which increases the degree of fragility of the entire financial structure (Minsky 1977). Indeed, if Ponzi units also increase their share of overall financial positions, the shock could have quite devastating effects on investment and income to the extent that the boom itself is now imperilled (Isenberg 1994, 203). The financial system is therefore subject to endogenous instability and vulnerable to small shocks, which could develop into a depressive spiral of debt-deflation.

Irving Fisher (1933) formulated a coherent debt-deflation theory of great depressions. Fisher argues that there are two central factors in the cumulative causation of economic depressions: (i) the accumulation of debt; and (ii) the diminishing purchasing power of the monetary unit. The onset of deflation sets off a chain of events, which leads to the cessation of debt validation and the emergence of a severe economic slump. Consequently, the liquidation of debts acts as both a cause and a catalyst for the onset of deflation. The more that debtors attempt to validate their obligations, the more difficult it becomes to liquidate their assets because of falling prices. The whole process becomes self-defeating. To quote Fisher (1933, 374): “The very effort of individuals to lessen their burden of debt increases it, because of the mass effect of the stampede to liquidate in
swelling each dollar owed. Then we have the great paradox which, I submit, is the chief secret of most, if not all, great depressions: the more that debtors pay, the more they owe.”

The “debt disease” leads inexorably to a “dollar disease” as the real value (or purchasing power) of the monetary unit tends to rise in the event of falling prices. The real value of debts will therefore also rise as the purchasing power of the monetary unit increases in relation to falling prices. The accumulation of debt acts as a powerful trigger in the inversion of the business cycle and could hasten a phase of severe liquidation of assets and financial retrenchment. The stress-selling of assets also culminates in a contraction of deposits and a fall in the velocity of circulation of money. As asset prices fall, the process becomes cumulative and self-reinforcing. In the absence of central bank intervention to inject liquidity into the system, the rate of bankruptcies increases, which is then amplified by a profitability crisis and the subsequent curtailment of investment. Rising unemployment and a fall in aggregate demand are transmitted through the multiplier effects of a decline in aggregate income. As Minsky (1980, 26) notes: “Significant incoherence occurs because market processes do not assure that effective demand always will be sufficient to yield profit flows large enough to enable bankers and businessmen to fulfil their commitments on debt, and the market reaction to such short-falls of cash flows tends to markedly depress asset values.” Indeed, equity bubbles tend to reinforce and support private sector deficit spending, which, in turn, fuels speculative propensities. But as profits fall, financial stress becomes widespread as asset prices tumble. Investment spending is drastically curtailed as individual firms attempt to limit their exposure to external finance and rebuild their internal savings. There is, accordingly, an inverse relationship between income growth and the accumulation of internal savings by the private sector (Parenteau 2001). At the same time, banks themselves also attempt to increase their liquidity preferences in the event of a build-up of non-performing loans.

What ultimately prevents the descent into a depressive spiral is the operation of automatic stabilisers made possible by the existence of a substantial state sector. Central banks are capable of injecting liquidity and temporarily acting as a lender of last resort to mitigate the deleterious effects of the financial crisis. Minsky incorporates the Kaleckian model in which government deficits and surpluses act as anti-cyclical mechanisms and prevent the economy from experiencing the extreme fluctuations of boom and bust. Aggregate profits are therefore equal to investment, plus an export surplus plus budget deficits. An increase in the export surplus will induce a rise in aggregate profits, all things being equal. A budget deficit has a similar effect to that of an export surplus. By incurring successive budget deficits, governments can increase the level of aggregate profits. Spending on armaments and wars is the classical means by which budget deficits tend to increase aggregate profits. As a general rule, profits will be depressed by a budget surplus but are boosted by budget deficits (Wray and Tymoigne 2008, 12). Similarly, monetary policy acts in a similar counter-cyclical manner, though its efficacy is quite limited during a general period of debt-deflation or the emergence of a liquidity trap.

Japan’s Phase of Debt Deflation

By the mid-1990s, Japan had acquired the dubious distinction of sliding into a prolonged phase of debt-deflation; a chronic condition that has not been witnessed since the Great Depression of the 1930s. The crisis of over-accumulation was also characterised by a pervasive “liquidity trap” (Krugman 1999). In its original exposition by Keynes in the
According to Wray (1998, 82):

This is the idea of the paradox of thrift: investment determines saving so that given low investment by firms when households are excessively thrifty, income falls until the aggregate of saving decisions (as determined by the marginal propensity to save) is consistent with the aggregate of investment decisions. Alternatively, aggregate saving cannot be increased by trying to have more, but only by investing more – which raises income and thus saving.

In other words, under the conditions of radical uncertainty, money reverts to its intrinsic role as a store of value. Confronted by an avalanche of non-performing loans, an increase in the liquidity preferences of banks themselves ultimately led to a sudden curtailment of lending. Japanese corporations also engaged in a process of prolonged deleveraging. Despite near zero short-term interest rates, Japanese corporations not only curtailed their demand for credit but accelerated their repayment of existing loans in order to restore their respective balance sheets. By 2002–03, net debt repayment in the corporate sector increased to over 30 trillion yen per year on average (Koo 2008, 18). In the context of saturated markets and an intensification of competition, the restoration of profitability was engineered not only through the repression of wages but also by a long, protracted strategy of deleveraging. Consequently, the level of aggregate demand was depressed by both a fall in the rate of investment and by the propensity of households to increase their rate of saving at the expense of private consumption.

This vicious circle witnessed the destruction of asset values as a result of falling prices, estimated at over three years of national output (Koo 2008, 27). Indeed, the cost to Japanese taxpayers of the bail-out of the major financial and insurance corporations was estimated at around 4% of gross domestic product (GDP) (20 trillion yen). At the same time, the cumulative loan losses incurred between 1990 and 2004 have been estimated at 91.5 trillion yen (18% of Japan’s 2004 GDP) (Hoshi and Kashyap 2004, 12). The only redeeming feature of Japan’s banking crisis is that it has not (as yet?) experienced a classic run by depositors (Krugman, Domínguez, and Rogoff 1998, 175). Depositors and holders of Japanese government bonds (JGBs) continue to finance Japan’s burgeoning public debt despite near zero interest rates. The interest rate of the five-year JGB (Japan’s benchmark rate) has experienced a long-term decline from 4% in 1994 to a mere 0.2% in 2012.

Despite successive rounds of fiscal stimulus, the Japanese economy remains mired in stagnation. It would be plausible to contend that in the absence of a sustained recovery in investment and output, expansionary fiscal and monetary policies have prevented a full-scale descent into a deflationary spiral. As Koo quite correctly claims: “Government spending played a critical role in supporting the economy, and only through these annual stimulus packages was the government able to prevent a deflationary gap from emerging” (Koo 2008, 25). In other words, Japan continues to enjoy the luxury of financing its public debt from private savings, while the vast majority (94%) of this debt is denominated in its own currency. With the official interest rate at close to zero, the financing of this public debt does not pose any real risks to the solvency of the government’s sovereign debt (Taggart-Murphy 2009, 3). There are essentially two reasons for Japan’s escalating public debt-to-GDP ratio. First, the primary deficit or the difference between government spending and tax revenues has risen quite sharply because of the collapse in tax revenues
as a result of the slump in nominal GDP. Government spending has also increased to finance increased social security with rising unemployment and an aging population. In other words, the automatic stabilisers have been activated and have prevented the economy from lurching into a depressive spiral. Second, the interest rate gap, or the difference between government interest costs (the yield on government debt) and the rate of nominal GDP, has been positive. As a result, the very low rates of nominal GDP have tended to increase the debt-to-GDP ratio despite very low rates of interest.

Japan’s secular stagnation has therefore imparted a burgeoning public debt burden, growing from 15% of GDP in 1990 to nearly 140% in 2012. If the total debt that has been incurred by Japan’s government agencies, including the Post Office, is included, the public debt ratio was estimated at 220% of GDP in 2012. Indeed, much of this sharp increase in Japan’s public debt occurred after 1997 and in the wake of the global financial crisis of 2007–08. It can be surmised that Japan’s rather incoherent fiscal stimulus programmes have not been sufficient to revive economic growth but have played a crucial role in stabilising the economy and averting a descent into a full-scale depression. The successive rounds of fiscal stimulus were never applied consistently enough to counter the onset of a deflationary gap. The multiplier effects of each round of fiscal stimulus have thus diminished over time as the public debt burden has inexorably risen in the absence of a sustained recovery in economic growth.

This argument in favour of a more concerted expansionary fiscal policy can be supported by the quite disastrous policies of fiscal retrenchment implemented by the Hashimoto government in 1997–98. In retrospect, the Hashimoto reforms represented a serious reversal in Japan’s Keynesian policies of fiscal and monetary stimulus; the deleterious consequences of which reverberated over the next decade. The Hashimoto administration had embarked on a programme of fiscal consolidation and attempted to reduce Japan’s fiscal deficit by 15 trillion yen. At the same time, the consumption tax was increased from 3% to 5%, which had quite a severe contractionary impact on the level of aggregate demand and led to a year-long economic slump. The ensuing credit crunch and collapse in tax revenue caused the fiscal deficit to increase sharply by 16 trillion yen by 1999. The traumatic experience of Hashimoto’s brief embrace of austerity was eventually abandoned by the Koizumi administration in 2002–03. Fiscal policy resumed acting as an automatic stabiliser and a mild recovery was temporarily engineered.

At the very epicentre of Japan’s descent into stagnation has been the longstanding fall in nominal wages. Wage growth has consistently lagged behind productivity growth. To be sure, unit labour costs (or compensation per head divided by GDP per capita) have been falling since the mid-1990s. The effects of deflation and rising unemployment have generated considerable uncertainty and discouraged private consumption from acting as an engine of growth. Both households and corporations have engaged in a self-reinforcing process of deleveraging, which continues to have a depressive impact on Japan’s potential rate of growth. Indeed, it is precisely this cumulative output gap, estimated as high as 5% of GDP per annum that prevents a sustained recovery and compels successive governments to run budget deficits in order to compensate for the lack of effective demand (Krugman 2000). The other mechanism by which effective demand can be augmented is the promotion of balance of payments surpluses.

Japan continues to suffer from a structural excess of saving in the private sector. This endemic problem is reflected in what Koo describes as a “balance sheet recession” in which solvent but highly leveraged corporations are reluctant to invest in new productive
capacity but are obliged, if not forced, to deleverage in order to restore profitability.\(^9\) As household saving began to decline as a result of an aging population, the high rate of domestic saving was increasingly driven by the accumulation of retained earnings from the corporate sector (Tyers 2012, 522–523). As has already been alluded to, after the collapse of the bubble economy, investment opportunities for the private sector evaporated. In the absence of potential new investment outlets, the process of deleveraging in the corporate sector has been accompanied by their willingness to invest in government bonds, even at very low interest rates.

In order to break out of the decade-long liquidity trap, the BoJ engaged in a sustained programme of quantitative easing (QE) between March 2001 and March 2006 in which it injected 25 trillion yen of reserves, or the equivalent to five times the required reserves of the banking system.\(^10\) The money supply increased by about the same amount to cover government borrowings over the same period. According to Koo: “The increased availability of reserves was totally irrelevant to growth in money supply because the banking system was awash in excess reserves long before quantitative easing began” (Koo 2011, 73–74). This first attempt at QE proved to be quite ineffectual. In the wake of the global financial crisis (GFC) in 2007–08, the Liberal Democratic Party (LDP), which had ruled for most of the past 55 years, was defeated by the Democratic Party of Japan (DP). However, the failure of the DP to orchestrate a recovery witnessed the election of a new LDP government, led by Abe in December 2012. The impact of the GFC on Japan’s economy was quite devastating. By February 2009, the volume of exports had fallen by almost 50% from their peak a year earlier. Indeed, by the first quarter of 2009, Japan’s GDP had collapsed by 8.4% on an annual basis. Aggregate profits also fell by two-thirds over the same period, while manufacturing profits had disappeared altogether, recording a net loss for the first time on record (Turner 2009, 125–127).

In response to the most severe recession since the Great Depression, the BoJ announced a programme of “quantitative and qualitative easing.” The aim has been to double the monetary base and more than double the average maturity of JGBs that it purchases. Under the Abe administration, an inflation target of 2% has been set by 2014 (Tabuchi 2013, 4). At the same time, the government launched another fiscal stimulus package of 10 trillion yen in the 2013 budget. Whether this ambitious monetary and fiscal strategy will eventually overcome the powerful deflationary headwinds – which have been entrenched for almost two decades – remains to be seen. The two possible channels through which this strategy might reverse Japan’s secular stagnation are: (i) a sustained yen depreciation, which improves Japan’s export competitiveness and increases their ability to export excess savings through a rise in the current account surplus; and (ii) by inducing negative real interest rates, which could stimulate investment (Wolf 2013). An inflationary upsurge would also have the effect of monetising the public debt.

The real danger of Japan’s implementation of QE is the possibility of igniting trade and currency wars with their rivals. This very real likelihood, especially in the context of sluggish international demand, is even greater because the US Federal Reserve is also pursuing a similar strategy in order to encourage a recovery of investment in the wake of the GFC.\(^11\) By running a current account surplus, the BoJ has intervened in the foreign exchange markets by creating domestic currency in order to buy other currencies, especially US dollars. The build-up of foreign exchange reserves, mostly denominated in US dollars, allows the BoJ to intervene at a greater scale and by so doing, prevents the yen from appreciating. Indeed, in the last six months of 2012, the yen had devalued by
20% on a trade-weighted basis. The Nikkei stock market index surged by a staggering 55% following the election of the Abe administration in December 2012 and May 2013 (Economist 2013). Some analysts have warned of the risks of yet another equity bubble engineered by the BoJ (Duncan 2012).

At the same time, the combined QE policies of Japan and the US have played a major role in the upsurge in the prices of commodities, equities and bonds. In the long term, the quite dramatic upsurge in commodity prices, most notably in food and energy, could generate a phase of cost-push inflation, which could eventually spill over into bond markets as fears of a resurgence of inflation put upward pressure on interest rates (McKinnon 2011). Moreover, higher interest rates could also provoke a stock market sell-off (Duncan 2013, 168). The quite extraordinary creation of fiat money by the US Federal Reserve, the BoJ, the Bank of England and, more recently, by the European Central Bank has created a “carry trade” in which a torrent of “hot money” has flooded into the higher growth, higher yield bond markets of the emerging markets and commodity exporters, setting off a commodity boom. The imminent collapse of this most recent commodity bubble could act as a powerful brake in the rather tentative recovery recently experienced in Japan and the US. In short, there is a very real possibility of the outbreak of currency wars as each country or region attempts to stimulate an export-led recovery through competitive devaluations.

Conclusions

Japan’s prolonged descent into a seemingly irreversible phase of debt-deflation over the past two decades is quite portentous. It could be the harbinger of a more profound global crisis that has already engulfed the peripheral states of Europe and appears to be threatening a sustained recovery in the US and the United Kingdom as interest rates are approaching close to zero. The evidence of Japan’s experience over the past two decades appears to support the Fisher-Minsky theory of debt-deflation. Despite the implementation of expansionary fiscal and monetary policies, albeit in a rather inconsistent manner, the Japanese economy has so far been unable to overcome these powerful and entrenched deflationary undercurrents. At the same time, the excessive level of corporate savings and the process of deleveraging prevent a substantial increase in investment despite interest rates at near zero. It might be more accurate to declare that the banking crisis is symptomatic of a much deeper structural distortion. Severe excess capacity has been built up over the past decades regardless of profitability. Domestic private consumption has been neglected over the decades because of a deliberate strategy to accumulate capital by investing in the capital goods sector. While this strategy of rapid industrialisation and export-led growth has been successful in terms of a “late-starter” in its efforts to catch up with their Western competitors, the downside has been a neglect of the development of the wage-goods sector. Quite simply, the long-term increase in the profit share of national income has caused chronic problems of excess productive capacity in the absence of a concomitant increase in real wages. As long as real wages lagged behind productivity growth, the problem of a severe lack of effective demand persisted and has become more endemic.

In this context, the problem is one of “surplus absorption.” In the absence of domestic outlets for profitable investment, Japan becomes more reliant on an export-led strategy of growth and the export of capital. The temptation of the Japanese authorities to embark
upon an aggressive export-led strategy of growth through a sustained yen depreciation carries with it quite serious risks. Despite the domestic problems of deflation and a liquidity trap, Japan continues to accumulate a current account surplus, most notably in relation to the US. A large proportion of this trade surplus has been accomplished by falling imports as a result of the stagnation of domestic demand. The problem of excess capacity will compel Japanese corporations to expand their exports in order to counteract a falling profitability on the domestic market. The burgeoning trade deficit in the US, however, could provoke retaliatory protectionist measures. The conditions are therefore quite favourable for the outbreak of a classical Keynesian trade war as each country pursues “a desperate expedient to maintain employment at home by forcing sales on foreign markets and restricting purchases, which, if successful, will merely shift the problem of unemployment to the neighbour” (Keynes 1936, 382–383). In the final analysis, Japan’s plan-rational and state-led developmental model appears to have reached its historical limits.

Notes

1 During the 1980s, the price of real estate rose by a factor of five. At their respective peaks, the total estimated value of Japanese land was 60% of world property values, while Japanese equities accounted for almost 40% of world stock market values (Linge 1998, 62).

2 To quote from Hoshi and Kashyap (2004, 6): “According to the land price indices compiled by the Japan Real Estate Institute, land prices for all uses roughly doubled from 1980 to their peak in 1991, but by 2003 land prices had fallen back almost to their 1980s level. As of 2003, land prices were still falling and on average were about 45 per cent below their peak value.”

3 “Ponzi” units are based upon the expected cash flows required to meet current financing commitments. The current cash flows are not sufficient to cover interest payments on outstanding debt, which essentially presupposes that a rise in future asset prices will cover their liabilities. Needless to say, these financing units are highly exposed to even small increases in the rate of interest, or a fall in asset prices. As Minsky (1992, 7) explains, “Such units can sell assets or borrow. Borrowing to pay interest or selling assets to pay interest (and even dividends) on common stock lowers the equity of a unit, even as it increases liabilities and the prior commitment of future incomes. A unit that Ponzi finances lowers the margin of safety that it offers the holders of its debts.”

4 This process of deleveraging is what Koo (2008) describes as the “balance sheet” recession, but he fails to acknowledge Minsky’s seminal contribution.

5 An excellent account of Japan’s liquidity trap is elaborated by Boltho and Corbett (2000, 5): “The Japan of the last decade could be a living example of Keynes’s ‘paradox of thrift’ – a country in which desired (or ex ante) savings exceed planned (or ex ante) investment by the private sector.”

6 According to Boltho and Corbett (2000, 6): “The existence of a gap between actual and potential output, at some 3.5% of GDP, is the single, strongest signal that aggregate demand is falling well short of productive potential.”

7 More than 50% of Japan’s 1,400 trillion yen of financial assets in 2008 were held in cash and deposits and a large proportion was invested in JGBs via the banking system (Economist 2010).

8 In 2003, for example, it was estimated that Japan required a budget deficit of 7% of GDP merely to achieve a steady state GDP growth rate of zero (Koo 2008, 145).

9 It has been estimated that the sum total of depreciation and retained earnings of Japan’s corporate sector was equivalent to 29.5% of GDP in 2011 (Wolf 2013).

10 QE is a euphemism for fiat money creation in order to lower the cost of borrowing in the credit markets. As soon as the official interest rate is at 0%, QE is the only other monetary instrument available to central banks to stimulate private investment.

11 The recent resort to QE by the US Federal Reserve represents a more perilous continuation of these US predatory, “beggar-thy-neighbour” type policies. Since the onset of the global credit crunch in 2008–09, the US Federal Reserve has injected enormous amounts of liquidity into the banking system. In the context of near-zero official short-term interest rates and the looming threat of a pervasive liquidity trap, the reserve has
injected over US$2 trillion during 2009–10 and another US$1 trillion in 2011–12. It is assumed that these expansionary monetary policies will revive bank lending, restore the housing market and stimulate consumer spending. However, instead of lending domestically, the US banks and hedge funds have engaged in speculative operations in foreign exchange and commodity markets. The flood of cheap dollars has destabilised international currency markets as US dollars are recycled back into low-yielding US Treasury securities by central bankers. Beyond a certain threshold, these enormous injections of liquidity could ultimately undermine confidence in the US dollar as an international reserve asset.

References


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