

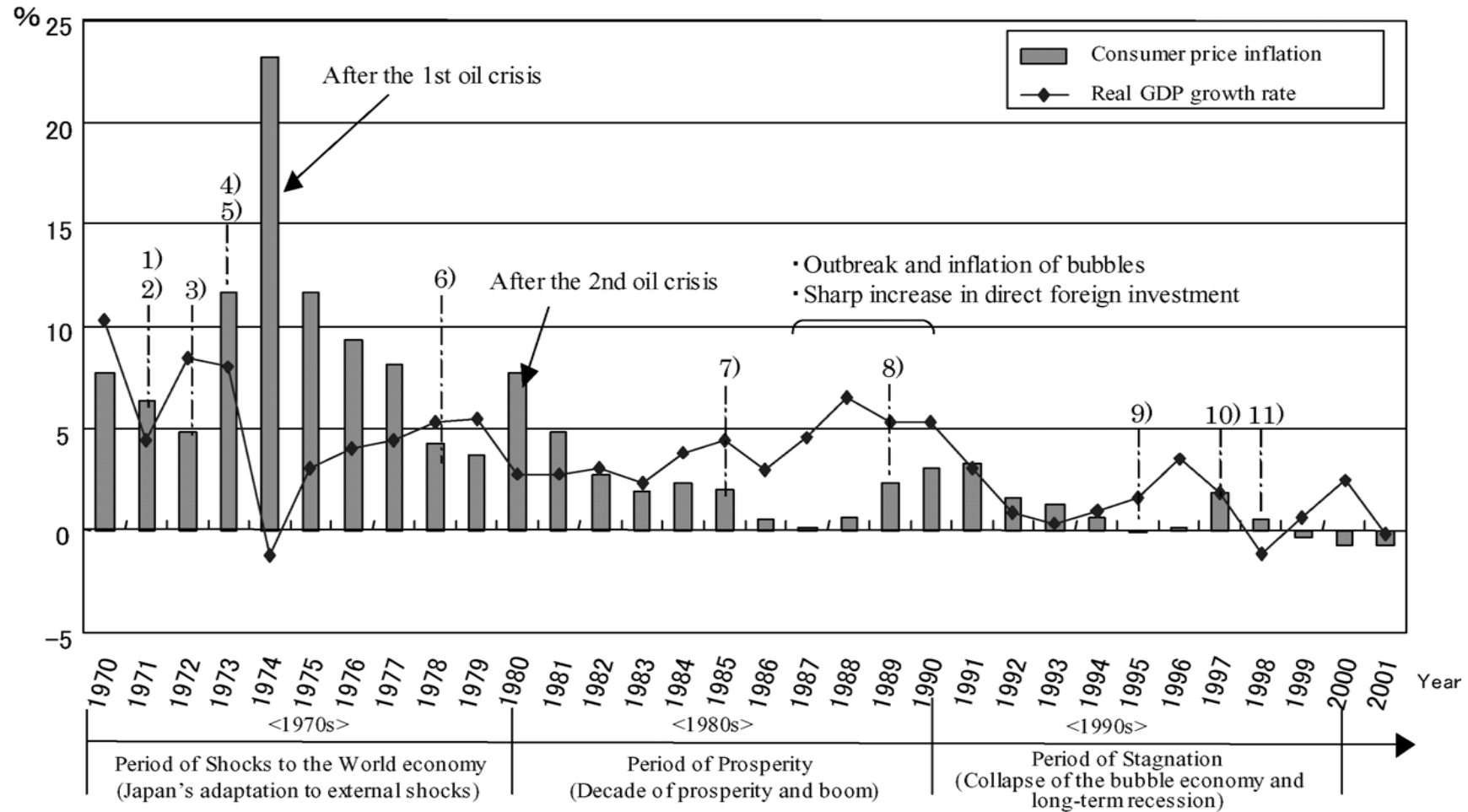
Trend of the Japanese economy and major topics in and after the 1970s

Economic and Social Research Institute

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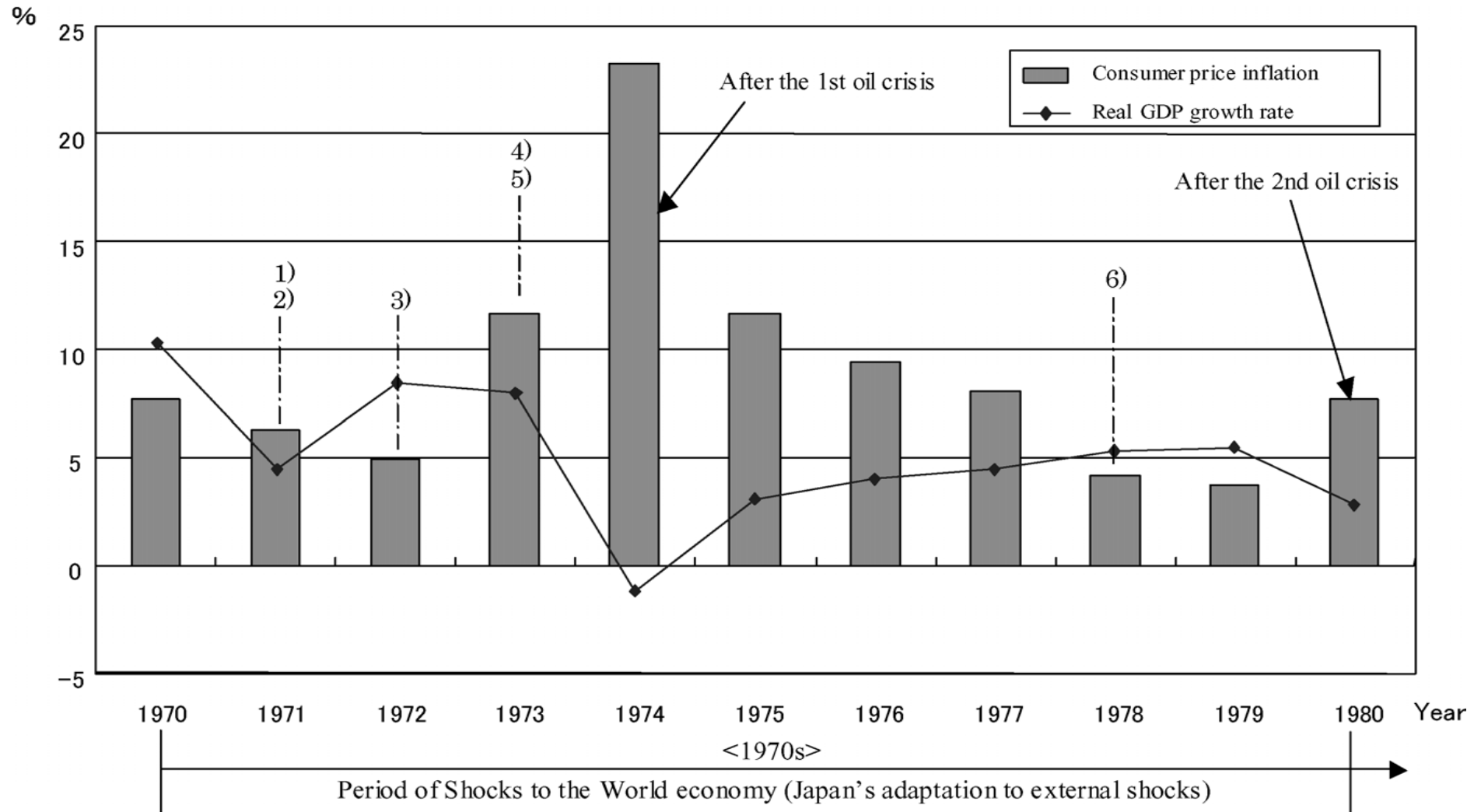
- 1) Suspension of the dollar's convertibility into gold (Nixon shock, 1971.8)
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- 5) Outbreak of fourth Middle East war (1973.10)
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- 10) Failure of Sanyo Securities Co., Hokkaido Takushoku Bank, and Yamaichi Securities Co. (1997.11)
- 11) Failure of the Long-Term Credit Bank of Japan (1998.10) and Nippon Credit Bank (1998.12)

**I. 1970s: Period of Shocks to
the World economy
(Japan's adaptation to external shocks)**

Trend of the Japanese economy and major topics in the 1970s



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1. Collapse of fixed exchange rate system and revaluation of yen

(1) August 1971: Suspension of dollar's convertibility into gold [Nixon shock]

- End of fixed exchange rate system (End of the fixed exchange rate (\$1=¥360) that lasted for 22 years)
- World currencies temporarily moved to flexible exchange rates. After ascertaining exchange rates at which markets calmed, a new fixed exchange rate system was adopted.

(2) December 1971: New exchange rates decided under “Smithsonian Agreements”

- \$1=¥308 (16.88% revaluation from \$1=¥360)
- The currency realignment under the Smithsonian agreements failed to correct world trade imbalance and calm currency unrest. Major currencies moved to flexible exchange rates.

(3) January 1973: Major currencies shift to floating exchange rate system

- The yen also shifted to a floating exchange rate system. At one time, it appreciated to \$1=¥260.
- Average exchange rate in 1973: 272.18 yen/dollar

(4) Impact of the yen's revaluation on the economy

Although the economy deteriorated in 1971 due to the yen's revaluation, it recovered swiftly and entered an expansion phase as early as 1972 for the following reasons:

- 1) Compared with U.S. inflation rate, which posted a sharp rise in the second half of the 1960s, Japan's inflation rate was low, making Japan wage cost advantageous by more than 10% to the U.S.'s wage cost. As a result, the export competitiveness of major Japanese industries improved.
- 2) To extricate the economy from the recession, stimulative fiscal and monetary policies were adopted. In particular, credit conditions were eased drastically as a result of four official discount rate cuts for a total of 1.5%.

2. “Japanese-archipelago remodeling boom” and signs of inflation

(1) “A Plan for Remodeling the Japanese Archipelago”*

Prime Minister Kakuei Tanaka, who took office in July 1972, promoted aggressive fiscal and monetary policies in order to implement “A Plan for Remodeling the Japanese Archipelago,” his pet project.

* “A Plan for Remodeling the Japanese Archipelago” is a concept aimed at solving the overpopulation and depopulation problems by building high-speed transportation networks, such as the Shinkansen, bullet train lines, and expressways, and by promoting industry relocation and establishment of regional hub cities across the country.

(2) Fiscal 1972 supplementary budget

As there were concerns about a deepening recession caused by the yen’s appreciation at that time, expansionary fiscal and monetary policies were advocated. In particular, the FY1972 supplementary budget that was passed by the Diet in November 1972, and was aggressive and ambitious in its size and contents, with its expenditures far exceeding the scope of natural tax revenue.

(3) Compilation of the Basic Plan for the Economy and Society (1973-77)

In addition, the Basic Plan for the Economy and Society (1973-77), with the catch phrase of “halving pollution and doubling welfare,” was compiled to realize an “active welfare society.” Terming fiscal 1973 “the first year of welfare,” the government drastically expanded social security benefits, such as pension. This, combined with the aggressive public investment plans, resulted in an unprecedentedly large-scale budget, with the initial budget for fiscal 1973 increasing 25% from the preceding year.

(4) Concerns about excess liquidity

As aggressive monetary easing was carried out, the money supply posted a sharp increase of 26.8% in fiscal 1972, following a 22.5% increase in fiscal 1971, threatening to raise land prices, stock prices, and commodity prices. As a result, the existence of excess liquidity began to be discussed.

(5) Signs of inflation caused by a sharp increase in demand

Demand increased faster than supply capability and the inflationary trend intensified as a result of the excessively expansionary fiscal and monetary policies aimed at:

- 1) arresting the deepening recession
- 2) promoting the plan for remodeling the Japanese archipelago, and
- 3) sharply expanding the welfare budget for an “active welfare society.”

	GDP real growth rate (%)	CPI growth rate (%)
1971	4.4	6.3
1972	8.4	4.9
1973	8.0	11.7

3. First oil crisis and runaway inflation

(1) Fourth Middle East War and surge in oil prices

- The fourth Middle East war broke out in October 1973 and OPEC announced a ban on exports of oil to hostile countries.
- The price of oil surged from 3 dollars per barrel to 12 dollars, an increase of fourfold, in several months.

(2) Sharp rise in prices in Japan

- The wholesale price index (WPI) rose 35% in the January-March quarter of 1974 over the previous year.
- The consumer price index (CPI) rose 26% in February 1974 over the previous year.
- “Runaway inflation” hit Japan, with shortages of goods (daily necessities, such as toilet papers and detergents) spreading across the country.

(3) Adoption of economic policies focused on price stabilization

- In addition to restrictive macro-economic policies, such as monetary tightening, individual prices were controlled.
- Prices calmed down gradually in 1974.
- Business stopped declining in early 1975 and began improving.
- The vicious cycle of “home-made inflation” was cut off at an early stage.

	WPI inflation (%)	CPI inflation (%)
1974	31.3	23.2
1975	3.1	11.7

(4) Corporations' response

- To extricate themselves from too much dependence on cheap oil, corporations promoted energy-saving, oil-saving measures, resulting in the development of energy-saving technology, energy-saving production system and energy-saving products.
- Industries as a whole shifted to a knowledge- and technology-intensive industrial structure. This has eventually contributed to strengthening the international competitiveness of the Japanese industry after the second oil crisis in 1979-1980.

4. Second oil crisis and victory over the crisis

(1) Oil prices rose once again

The Middle East situation intensified after the Iranian Revolution in late 1978, resulting in tighter oil supplies worldwide. After the Iran-Iraq war in 1980, oil prices jumped from around 12 dollars per barrel to 35 dollars in 1981, nearly a three-fold increase.

(2) Global impact of the 2nd oil crisis

The 2nd oil crisis had as much impact as the 1st oil crisis on the economies of oil consuming countries throughout the world. In particular, it had a damaging impact on the countries that had been suffering from home-made inflation as a result of their inflation-tolerating policies after the 1st oil crisis. For example, shortage of gasoline became serious in some regions of the United States, and the country's CPI posted a double-digit increase of 13% in 1980.

(3) Japan's response

On the other hand, since Japan had overcome inflation by adopting tighter fiscal and monetary policies and had been successful to a certain extent in shifting to an energy-saving industrial structure and in producing energy-saving goods and services, Japan was able to absorb the rise in oil prices with comparative ease by implementing stringent policies for a short period of time. As a result, Japan was able to achieve better performance than other major countries and strengthen its international competitiveness.

	Real growth rate of GDP (%)	CPI inflation (%)	WPI inflation (%)
1977	4.4	8.1	1.9
1978	5.3	4.2	-2.6
1979	5.5	3.7	7.4
1980	2.8	7.7	17.7
1981	2.8	4.9	1.4

5. External shocks and the Japanese economy's adaptation

(1) Frequency of external shocks

The 1970s were a tempestuous period for the world economy. For Japan, it was a decade of one external shock after another.

- Two Oil shocks: 1974, 1979-1980
- Two sharp appreciations of the Yen: 1971-1973, 1978 (October: ¥176/\$1)

(2) Japanese economy's adaptation

The Japanese economy made every effort to adapt to the external shocks.

- Macro-economic policies to adapt to the external shocks ... Tight money policy
- Structural reform to adapt to the external shocks ... Shift to a knowledge-intensive, high value-added industrial structure, development of energy-saving goods and services

(3) Response of Corporations

Japanese corporations also strengthened their structure to minimize the effect of external shocks and supplied the following hot-selling products to the world market:

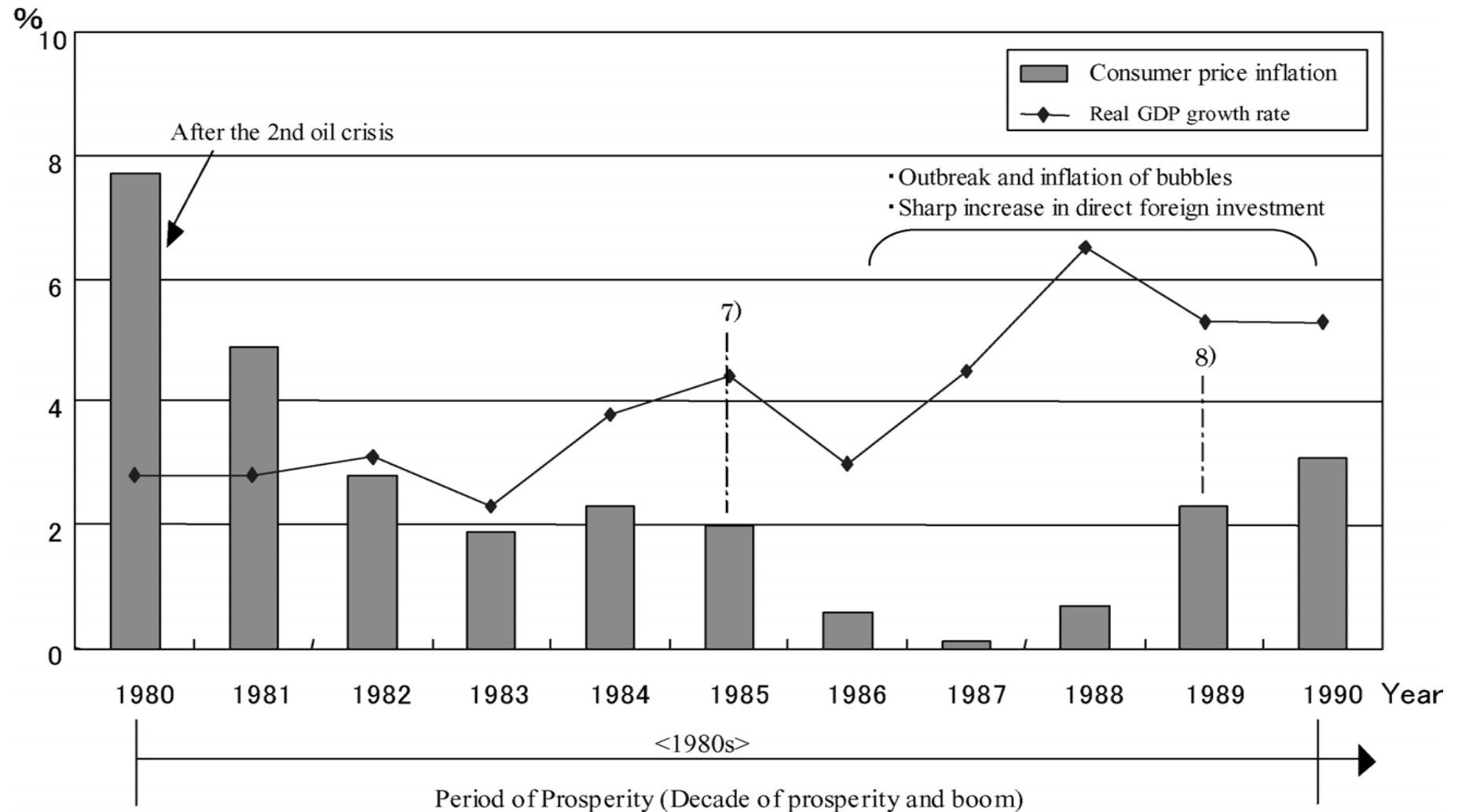
- Numerically controlled machine tools
- Home electric appliances of superior performance, convenience, and design (Made inroads into the world market)
- Energy-saving (fuel-efficient) automobiles

(4) From victory over the external shocks to prosperity

Japan overcame the external shocks (and ensuing destabilization and recession) that broke out frequently in the 1970s, achieved structural changes, developed and supplied hot-selling products, and entered a decade of prosperity on the 1980s.

II. 1980s: Period of Prosperity (Decade of prosperity and boom)

Trend of the Japanese economy and major topics in the 1980s



7) "Plaza Accord" (1985.9) and Adjustment of strong dollar

8) Nikkei Stock Average hits all-time high of 38,915 (1989.12, Closing session of the year)

1. Export-led economy set in place

(1) Reaganomics and strong dollar

- The monetary tightening (a new monetary adjustment policy targeting the growth of money supply “Reaganomics”) implemented in the United States to escape from the impact of the 2nd oil crisis and contain inflation resulted in high interest rates in the U.S., inflow of capital into the U.S., and a strong dollar.
- The dollar appreciated sharply against the yen in 1979 and moved in the 220-260 yen range from 1980 until October 1985, or shortly before the Plaza Accord.

(2) Japan's current account balance moved into the black in around 1970.

The dollar's uptrend against the yen in the first half of the 1980s dramatically strengthened the price competitiveness of the Japanese export industry and increased Japan's current account surplus further.

	Current balance (in ¥1 billion)	Current balance (in \$100 million)	Current balance/GDP (%)
1983	4,959	208	1.7
1984	8,349	351	2.7
1985	11,970	503	3.7
1986	14,244	849	4.2*

(Reference: During the 2nd oil crisis)

1979	-1,972	-90	-0.9
1980	-2,576	-114	-1.1

* The current account surplus/GDP of 4.2% is the highest figure so far.

(3) Increase in exports and export-led growth

- The yen's downtrend in the first half of the 1980s further strengthened the export competitiveness of the Japanese manufacturing industry, which had already been strengthened as a result of its adaptation to the two oil crises in the 1970s and the fluctuations of exchange rates. In particular, exports by the machinery industry, such as electrical machinery, transport machinery, and general machinery, increased dramatically.
- As a result of a sharp increase in Japanese exports, Japan-U.S. trade frictions intensified. The government of Prime Minister Yasuhiro Nakasone adopted the "Action Program for the Improvement of Market Access."
- The export-oriented economy, in which economic growth is supported by exports and capital investment necessary for exports, have been firmly set in place, and its structural characteristics still remain today, despite of the calls for shift to a domestic demand-led economy.

2. Major creditor nation in the world

(1) Japan is still an “immature creditor nation”

- According to the “Development Stage Theory of International Balance of Payments” (Charles P. Kindleberger, et al), Japan is believed to have reached a stage of “immature creditor nation” (a nation having a surplus in both the goods and service account and investment income account) in the 1970s. (Fiscal 1984 White Paper)
- Since both the goods and service account and investment income account are in the black in the stage of an “immature creditor nation,” Japan tends to have a huge current account surplus. When the U.K. and the U.S. were at this stage, the ratio of current balance to nominal GDP in those countries was high at 2~4%. (It can be said that they exported capital by that amount.)

(2) Road to “mature creditor nation”

- In view of the fact that it took nearly half a century (40~50 years) for both the U.K. and the U.S. to shift from “immature creditor nations” to “mature creditor nations” (surplus in investment income account but deficit in goods and service account), it will be in around 2010-2020 when Japan reaches the stage of “mature creditor nation” and begins to have a goods and service account deficit. Until then, Japan is likely to keep posting a huge current account surplus.
- In fact, Japan still posts a huge surplus of the current account as an “immature creditor nation” and is providing massive amounts of capital to the world through direct investment, etc. Japan is the largest net creditor nation in the world.

3. Adjustment of strong dollar and advent of boom

(1) Adjustment of strong dollar under the Plaza Accord

- The adjustment of strong dollar proceeded rapidly under an agreement (Plaza Accord) reached at a meeting of the finance ministers of the five advanced countries (G5) in September 1985.
- The Japanese yen appreciated by 70 yen in one year from ¥240/\$1 shortly before the Plaza Accord in September 1985. The average exchange rate of the yen to the dollar stood at 168 yen in 1986, 144 yen in 1987, and 128 yen in 1988.

(2) Impact of yen's appreciation

- The yen's steep appreciation dealt a heavy blow to some manufacturers and raised concern about a strong yen-caused recession. In order to cope with the strong yen-caused recession, the official discount rate was cut a total of six times to 2.5% by February 1987, and aggressive fiscal policies, mainly expansion of public investment, were adopted. As a result, the recession came to an end in a short period of time, and an economic expansion led by domestic demand began around the end of 1986.

(3) Advent of boom

- Thanks to expansionary fiscal and monetary policies and an increase in real income as a result of a sharp improvement in terms of trade caused by the adjustment of strong dollar, a consumption boom, such as the expansion of demand for durable consumer goods (large-screen TVs and luxury cars), began to be created led by the private sector.
- As the boom expanded, imports of cars and arts and overseas travels increased sharply, also helped by the yen's appreciation. As a result, current account surplus began to decrease from the peak in 1986.

(Ratio of current account to nominal GDP)	
1986	4.2% (peak)
1987	3.4%
1988	2.7%
1989	2.1%
1990	1.5%

4. Outbreak and inflation of bubbles

(1) Sharp rise in asset prices

- From around 1987, when the boom began, asset prices, such as land prices and stock prices also began to rise sharply.
- As for land prices in the Tokyo metropolitan area, land prices rose mainly in the commercial districts within inner Tokyo until around the first half of the 1980s. The areas that posted a sharp rise in land prices expanded to commercial districts in Tokyo metropolitan wards by around 1985, residential districts in Tokyo metropolitan wards and outer areas of Tokyo by around 1986, and to residential districts in southern Kanto (Tokyo, Kanagawa, Saitama, Chiba) by around 1987.

(2) Land prices: Myth of ever-higher land prices and a rise in capital gain expectations

- Land prices had been far higher than their earnings discount value (fundamental prices) by the second half of the 1980s.
- This was due to the fact that expectations on capital gains increased against the background of a myth that land prices would forever continue to rise, a myth peculiar to Japan, and that this in turn led an to abnormal increase in land speculation.

(3) Land prices: Land prices pushed stock prices higher

- Stock prices also began to rise sharply along with land prices by around 1986. In the second half of the 1980s, stock prices, as measured by various indexes, such as price earnings ratio, stood at an unusually high level by international standards.
- TOPIX (a stock index that takes the market capitalization on Jan. 4, 1968 to be 100) rose to 2881.37 in late 1989, a 6.3-fold gain in 10 years from late 1979 (459.61).
- A stock price usually reflects the present discounted value of its returns. But, in the case of Japan, it often reflects the net asset (assets minus liabilities on the balance sheet) held by corporations. Therefore, when the assets held by corporations increased due to a temporary rise in land prices, the net assets held by the corporations increased, leading to a rise in the stock prices of the corporations.

(4) Upward spiral of stock prices and land prices, and the formation of bubbles

- Since a rise in land prices meant a rise in the collateral value of land, it made it easy for financial institutions to provide loans for the purchase of stocks and land and this in turn contributed to the rise in stock and land prices. In this way, stock prices and land prices multiplied their upward spiral.
- In this way, the adjustment of the strong dollar and accompanying super-easy monetary policies caused excessive liquidity and realized expectations of striking rises in stock and land prices, resulting in the formation of asset bubbles.

5. Sharp increase in Japanese direct investment abroad and the development of East Asian economies

(1) The yen's appreciation and a sharp rise in direct investment abroad

- In order to cope with the yen's sharp appreciation (adjustment of the strong dollar) after the Plaza Accord of September 1985, automakers and electric/electronics manufacturers, etc. rapidly increased direct investment in cheap labor markets of East Asia.
- Japan's direct investment abroad surged from 14.5 billion dollars in 1986 to 48.1 billion dollars in 1990. Japan became the largest investing country in the world in 1990. (But, Japan's direct investment abroad shrank to 13.7 billion dollars in 1993 due to the collapse of the bubble economy.)

(2) Formation of production network in East Asia ... and the "East Asian miracle"

- As a result of the direct investment, East Asian production networks were formed in ASEAN countries as well as in Asian NIEs, triggering strong economic growth in these countries.

(Reference) 1985-1990 economic growth rate (annual average; in real terms)

Thailand: 10.4%, South Korea: 10.0%, Taiwan: 8.7%, Singapore: 8.0%, Hong Kong: 7.9%, Malaysia: 6.8%, Indonesia: 6.3%, the Philippines: 4.7%, (China: 5.1% ... The Chinese economy also began to take off.)

- The inflow of direct investment and the advancement/expansion of industrial production appear to have made the "East Asian miracle" definite.

6. Superiority of the Japanese corporate system

(1) Superiority of the Japanese-style market economy system

- The brilliant success of the Japanese economy in the second half of the 1980s is attributed to the superiority of the Japanese-style market economy system, especially the Japanese-style corporate system. (Fiscal 1990 economic white paper)
- It is said that the “Japanese-style management” and “Japanese-style trade practices” are reasonable and can be applied universally.

(2) Characteristics of the Japanese-style management

1) Advantage of long-term employment in technology development

Since long-term employment fits with education and training, such as on the job training (OJT), it makes it easy to acquire corporation's original technology and is more likely to lead to research and development.

2) Merit of focusing on field work

Since horizontal communication is easy, it often leads to technology and product development in the fields of application. In addition, it enhances workers' willingness to work, as they are given strong mandates.

3) Corporate Management Goal

Contrary to U.S. corporations that place emphasis on short-term profits and growth, Japanese corporations focus on long-term profits and growth. This helped to promote investment from a long-term viewpoint and to enhance technological development, contributing to the strengthening of the international competitiveness of Japanese corporations.

(3) Characteristics of Japanese-style trade practices

1) Merits of long-term, lasting trade

- Advantage in product pricing and quality and supply stability

2) Merit of production line (trade relation between finished product makers and parts makers)

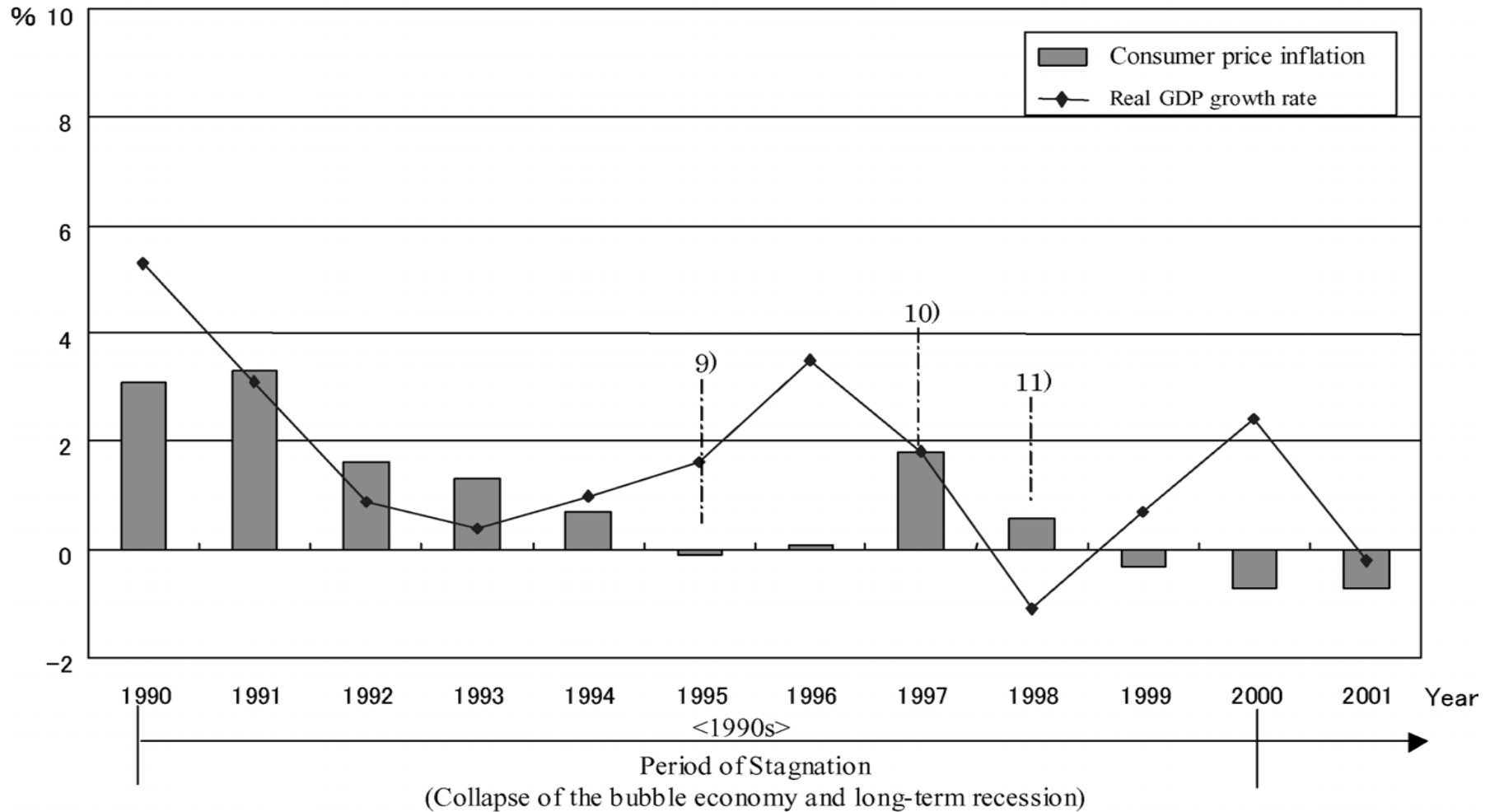
- Cost reduction and speedy technology/product development through information sharing and cooperation
- Enhancement of technology development capability through the introduction of design-in (a system under which a parts maker submits a blueprint and a finished product maker approves it).

(4) Advantage of Japanese-style corporate system multiplied by the bubbles

It can be said that the superiority of the Japanese-style management and Japanese-style corporate system is what drew attention in the second half of the 1980s, and was amplified by the demand, which was bloated by the sharp rise of asset prices, such as land prices and stock prices, in excess of their equilibrium prices. (In other words, it was an advantage multiplied by the bubbles.) In fact, when the portion of the demand caused by the bubbles was removed in the 1990s, various problems, such as corporate governance and the main bank system, emerged and the Japanese-style corporate system lost its luster.

**III. 1990s: Period of Stagnation
(Collapse of the bubble economy
and long-term recession)**

Trend of the Japanese economy and major topics in and after the 1990s



9) Plans to dispose of housing-loan companies decided (1995.2)

10) Failure of Sanyo Securities Co., Hokkaido Takushoku Bank, and Yamaichi Securities Co. (1997.11)

11) Failure of the Long-Term Credit Bank of Japan (1998.10) and Nippon Credit Bank (1998.12)

1. Collapse of the bubbles and its impacts

(1) Collapse of the bubbles ... Sharp decline in asset prices

1) Stock price

The average stock price (Nikkei-Dow Jones average) on the Tokyo Stock Exchange surged in the second half of the 1980s, posting a 3.1-fold gain from 12,598 at the end of September 1985 to 38,915 (all-time high) at the end of December 1989.

Then, the stock average plunged, dropping to 14,309 at the end of August 1992, a level nearly one-third of its all-time high. It remained on a sluggish, long-term downward trend thereafter and plunged to the post-bubble low of 7,862 on March 11, 2003.

2) Land prices

a. Land prices in Tokyo area (commercial districts)

1990 (peak) ... Four-fold gain from the level in 1985

1996 ... Decline to the level of 40% of the peak level

⋮

2002 ... Decline to the level of one-fourth of the peak level

b. Land asset value

	Land asset value (in ¥1 trillion)	Capital loss (in ¥1 trillion)
1990	2,455	↓ 180
1991	2,275	↓
⋮	⋮	↓ 1,000
2000	1,544	
2001	1,456	↓

The loss of land asset value (capital loss) in the 11 years from 1990 reached 1,000 trillion yen. Land prices continued their downtrend thereafter.

(2) Direct impacts on consumption and investment

1) Suppression of consumption

- Decline in consumption propensity due to negative asset effect
- Deterioration of consumer sentiment due to a plunge in the prices of assets (stocks, houses, land, etc.) held by households.

2) Suppression of investment (business investment)

- Spread of bearish sentiment among business managers and expansion of stock adjustment
- Financial institutions' reluctance to lend and small- and medium-sized enterprises' fund shortages (lack of cash flow)

2. Deterioration of corporate/household balance sheet

(1) Collapse of the bubbles and deterioration of the balance sheet

- The deterioration of the corporate/household balance sheet continued for a long time due to the collapse of the bubble. (A decline in asset prices eroded asset value and increased liabilities, leading to the deterioration of the balance sheet.)

(2) Deterioration of the corporate balance sheet and suppression of business investment

- Deterioration of the corporate balance sheet is a negative factor for business investment, as it prompts corporations to reduce their debt ratio.
- Since the decline of asset prices (land prices, in particular) lasted for a long time (more than 10 years up to now), corporations failed to adjust balance sheets and this, in turn, suppressed business investment.

(3) Deterioration of the household balance sheet and suppression of consumption

- The deterioration of household balance sheets continued for a long time, resulting in suppressed consumption, as the acquisition of dwelling houses, particularly during the years of the asset-inflated economy, swelled liabilities and as house prices thereafter remained on a long-term downtrend.

(4) Prolonged balance sheet adjustments as the cause of the protracted economic slump

- Looking at the final analysis, there's no doubt that the long-term deterioration of balance sheets caused by a decline in asset prices and the prolonged balance sheet adjustment are the cause of the protracted economic slump in the 1990s.

3. The bad debt problem and financial system unrest

(1) Increasing troubled loans and deterioration in earnings of financial institutions

- Loans extended to real estate-related industries, such as real estate, construction, distribution, and non-banks, etc., that had swollen during the asset-inflated bubble economy, turned sour due to the long-term decline of asset value following the collapse of the bubbles, resulting in increasing non-performing loans. (Corporations' bad debts are inextricably linked to non-performing loans held by financial institutions.)
- The situation deteriorated into a grave crisis, as financial institutions' business profits weakened and paper profits on stocks were depleted, while non-performing loans increased.

(2) Successive failure of major financial institutions

- Against this background, the confidence in the financial system fell drastically as a result of the successive failure of major financial institutions - Sanyo Securities Co, Hokkaido Takushoku Bank, and Yamaichi Securities Co. - in November 1997.
- In addition, the failure of the Long-Term Credit Bank of Japan in October 1998 and Nippon Credit Bank in December the same year intensified the financial system unrest, drastically deteriorating consumer and business sentiment and dealing a heavy blow to the real economy.
- Real GDP contracted 1.1% in 1998, the first contraction since the first oil crisis of 1974 (contraction of 1.2%).

(3) Financial system unrest and infusion of public funds

- Financial institutions' capital base, in real terms, shrank due to a decrease in paper profits caused by lower stock prices amid increasing non-performing loans, making them reluctant to lend (credit crunch).
- In order to calm down the financial system unrest, the government infused a total of 9.3 trillion yen in public funds into major banks in March 1998 and March 1999.
- To date, however, the problem of non-performing loans remains unsolved, as the decline in asset prices has been continuing due to deflation.

(4) Primary cause of the financial system's unrest ... Lack of awareness of the crisis and the postponement of countermeasures

- The root cause of the financial system's crisis is "the postponement of taking counter-measures, in addition to the lack of early awareness of the financial crisis."
- For instance, with regard to the "disposal of the problem of housing loan companies," the cabinet decision on disposal measures, including the infusion of 685 billion yen of public funds, came on Dec. 19, 1995, more than five years after the collapse of the bubbles.
- We would have to say that the five-odd years up to the cabinet's decision was a period (five years that invited the crisis) of
 - 1) lack of awareness of the crisis
 - 2) policy postponement
 - 3) chain of irresponsibility.

4. Protracted recession

(1) Primary factors behind the protracted recession

- The long-term economic recession has been continuing for more than 10 years after the collapse of the asset-inflated bubble economy. As was described earlier, the primary factors behind that are the following situations have been in place since the collapse of the bubble.
 - 1) Deterioration of corporate/household balance sheets
 - 2) Problem of non-performing loans and financial system unrest.
- During the 1990s, we experienced a recovery phase twice in short-term business cycles, but the both recovery phases lacked momentum. (The real GDP growth rate was less than 1% in seven of the 10 years.) On this point, it can be said that the two primary factors behind the long-term stagnation suppressed the revitalization of corporations, households, and the financial institutions.

(2) Necessary condition to break out of deflation

- The consumer price index posted negative growth in 1999 and kept falling the next four years, prolonging deflation. (The Cabinet Office defines recession as “two consecutive years of decline in consumer prices.”)
- If deflation continues, the primary causes of the long-term recession will not improve, as the balance sheet does not improve and non-performing loans increase. For this reason, it can be said that overcoming deflation is the necessary condition for overcoming the long-term recession.

5. Forfeiture of the Japanese-style market economy system

The Japanese-style market economy system, which had been highly evaluated as the factor behind the brilliant success of the Japanese economy in the 1980s, has been viewed critically as the factor that has brought about the long-term stagnation of the Japanese economy in and after the 1990s. It is true that the Japanese-style market economy system has drawbacks. But, it is also true that the drawbacks have been exaggerated due to the collapse of the bubbles and the prolonged recession.

(1) Government-business cooperation-type economic system

- In the 1970s and the 1980s, the system was highly evaluated as effective in planning and implementing economic policies for economic growth, allocating investment to growth areas, and promoting energy savings.
- In and after the 1990s, however, the system has been criticized as the source of the collusion structure that forms an iron triangle of politicians, bureaucrats and business.

(2) Japanese-style corporate system

- Until the 1980s, the main bank system, corporate cross-shareholdings, transaction through business affiliation, and subcontracting structures, such as design-in, were highly evaluated as excellent systems.
- However, in and after the 1990s, it was pointed out that the Japanese-style corporate system has many drawbacks with regard to corporate governance, such as the lack of competition through market, opacity of corporate governance, and lack of accountability.

(3) Japanese-style employment system

- Until the 1980s, the Japanese employment system, such as long-term employment, seniority-based wage system, and in-house training, were highly evaluated as contributing to the stability of employment and as having advantages in technology development.
- In and after the 1990s, however, the Japanese-style employment system came to be criticized as a system having problems with regard to competition and demonstration of human capabilities. It is now pointed out that what is important is mobilization of the labor market through introduction of merit-based wage system, expansion of the scope of temporary workers' jobs, and improvement of work conditions of part-time workers.

IV. Challenges for 21st century

With the long-term recession of the Japanese economy continuing in the early years of the 21st century, the sense of stagnation still haunts the entire economy and society.

In order to break out of the sense of stagnation and the long-term recession and to achieve new development in the 21st century, it is necessary to address the following problems.

- 1) breaking free from the long-term deflation
- 2) promotion of structural reform
- 3) creation of a new Japanese-style market economy system.

1. Breaking free from the long-term deflation

- Breaking free from the long-term recession is the necessary condition for the return to a dynamic economic-growth path through the improvement of household/corporate balance sheets.
- In the “Reform and Perspectives - FY2002 Revision” decided by the Cabinet on Jan. 24, 2003, the government promises it can overcome the deflation after the intensive adjustment period ending in fiscal 2004. The government is obligated to make all-out efforts to honor its public promise.
- In order to break free from the deflation, the role played by the financial policy is particularly large. The financial policy should be revamped and include such policies as inflation targeting and more quantitative monetary easing.

2. Promotion of structural reform

- The government of Prime Minister Junichiro Koizumi, which was inaugurated at the beginning of the 21st century (April 2001) came up with a catch-phrase, “No Economic Recovery without Structural Reform,” and in June 2001 decided the “Basic Policies for Macroeconomic Management and Structural Reform of the Japanese Economy.”
- The Basic Policies shows the government's basic idea of “mobilizing economic resources, such as labor and capital, from inefficient sectors to highly efficient sectors through creative destruction and structural reform and using them as the source of economic growth.”
- In addition, in June 2002, the government decided “Basic Policies for Economic and Fiscal Policy Management and Structural Reform 2002” (economic revitalization strategies ... six strategies and 30 action programs), calling for:
 - 1) tax system reforms, local administrative and fiscal reforms, and social security system reforms, etc.
 - 2) acceleration of the reforms of government expenditures,
 - 3) measures by the government and the Bank of Japan to “overcome deflation”
 - 4) promotion of “Economic Revitalization Strategies,” including the establishment of “special structural reform areas”

It is hoped that the government will take powerful measures for the structural reforms.

3. Creation of a new Japanese-style market economy system

- The Japanese-style market economy system appears to have lost its luster in the 1990s. But the U.S.-style market economy system also has many drawbacks as can be seen from the collapse of the IT bubble and corporate accounting scandals.
- As for the Japanese-style corporate system, its drawbacks, such as inadequate corporate governance, should be improved and its good points, such as emphasis on long-term goals and the system that brings out creativity like design-in, should be focused on.
- As for the Japanese-style employment system, the establishment of a wage system that gives incentives to the demonstration of human capabilities and the mobilization of the labor market should be promoted, while preserving its good points, such as stability of long-term employment and advantages in technology development.
- In addition to the above, it is important to create a new Japanese-style market economy system that attaches importance to efficiency, fairness and transparency through the establishment of a new public-private partnership (PPP) by utilizing the good points of the public-private cooperative-type economic system and removing the drawbacks of the system.