Rethinking Japan's "Lost Decade": Some Post-Crisis Reflections

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There are many parallels and similarities in the aftermaths of financial crises. What distinguishes the current state of the world economy four years after the global economic crisis from the situations of previous crises and from Japan's "Lost Decade"? What can this imply for the world economy in the future?

The Crisis and its Long Aftermath

Four years have passed since the outbreak of the global financial crisis. World financial markets now seem to have regained a measure of stability from its immediate aftermath thanks to swift and forceful policy actions taken by many governments and central banks working in concert. The sense of panic has certainly subsided and the desperate pessimism has been gradually replaced by cautious optimism. There seems to be more confidence now on the policy actions that should be taken, although differences still exist among policymakers over the speed and the magnitude with which they need to be implemented. The initiatives to reform the financial system to prevent future crises were launched globally, mostly in the G-20 framework. Remarkable progress has been made on many fronts, including in strengthening banks' capital adequacy standards and dealing with systematically important financial institutions. All of these developments are brightening prospects for the world economy.

The current state of the world financial system, however, is far from normal. While global economic growth has been helped by the buoyant economic development of emerging market economies, the growth of developed economies seems still hampered by the suboptimal health of their financial systems. Deleveraging has been prevalent and seems to have increased in the last four years. To cope with liquidity crises and deflationary impacts, central banks have resorted to bold non-traditional policies and expanded their balance sheets on an unheard of scale. No signs of reversing these policies are likely for the foreseeable future in the United States, Europe or Japan. Rather, the policy debate is mostly focused on whether we need another round of monetary expansion. The bold and unconventional monetary policies are affecting the foreign exchange markets and the relative competitiveness of countries as well is creating an unprecedented environment for policymakers. At the same time, many countries have sharply increased their public debt in response to the financial crisis and from high spending and lackluster tax revenues. Efforts to contain public sector debt are being made in those countries, but progress seems slow given the need to sustain demand in addition to the political and social difficulties that any fiscal reform would entail.

Under these circumstances, the core function of the financial system of allocating scarce risk-taking capital for the future growth of the economy seems constrained everywhere, and the role of the financial system is overshadowed by the need for securing financing for the public sector.

Implementation Challenges Rising

While financial crises are caused by similar underlying factors, the past four years revealed that there are three major aspects that have made this global financial crisis distinctly different from previous financial crises. These factors will continue to pose significant challenges to policymakers not only at the current juncture but also over the foreseeable longer-term horizon. The implication of these factors will affect the way the financial system will evolve and will impact the performance of the world economy in the long run.

First, the financial system has clearly shifted from a bank-based to a market-based system. A market-based financial system allows fair and flexible allocation of risk and returns, and efficient allocation of capital and sustainable economic growth. It brings about enormous benefits to the economy by strengthening financial freedom and inclusion, allowing entrepreneurship to flourish. At the same time, under the market-based system, the potential ability of debtors to repay, regardless of whether they are corporate, household or sovereign, is quickly assessed by the markets and reflected in market prices. This encourages prompt corrective action, contributing to the stability of the financial system under normal circumstances. When a crisis hits, however, it leads to swift deterioration in the quality of the balance sheets of creditors and causes concomitant liquidity problems, particularly for banks. Even in the cases where borrowers are concentrated in specific sectors or countries, the impact spreads across the globe instantly through rapid balance sheet effects and strains in liquidity positions. Any potential vulnerabilities of the financial system are exposed much more quickly than a decade ago, compounding the challenges to policymakers.

The European crisis highlighted this point. In the immediate wake of the global financial crisis in 2008, blame was directed at the United States. Critics made a number of points, including reckless lending by mortgage companies, excessive borrowing by consumers, and inadequate oversight by regulatory agencies. However, it became immediately clear that the crisis exposed the weaknesses and vulnerabilities in the financial systems everywhere and especially in Europe, where the impact turned into an unprecedented crisis of confidence. The underlying fiscal imbalances and differences in internal economic fundamentals within Europe became clear.

A weakness in the financial system impacts the real economy, as credit becomes dangerously tight, consumer confidence plunges, and unemployment surges. The deterioration of the real economy, in turn, adversely affects the soundness of financial institutions and increases the risk of a serious vicious cycle. No country is immune to these effects. The initial complacency is replaced by the loss of pride and humility. Governments and financial institutions are responding quickly and boldly, but it takes considerable time for these efforts to bear fruit, testing the political will of policymakers and the patience of voters.

The second aspect relates to the cost and responsibility of resolving financial crises. With the emergence of highly integrated financial markets, it has become much more complicated to assess the real burden borne by various stakeholders as it involves much greater cross-border implications. When the financial crisis hit Japan about a decade ago, the Japanese government declared that Japan would not be the one to trigger a global financial crisis. The crisis was largely a banking sector crisis and the government effectively succeeded in containing the impact within its own borders. The cost of resolving it was also shared mostly within Japan's borders. In the context of the current crisis, however, it seems extremely difficult for any country to make such a declaration. The crisis in Europe is a glaring example of this difficulty, not just because of the single currency but also because of the very high degree of economic integration.

The solution for today's financial crisis requires a far more systematic and globally consistent approach. In the aftermath of any financial crisis, the post-crisis political situation is prone to creating an environment in which populist policy actions are appealing. Tensions arise between the desire of policymakers to appear tough and forceful to introduce drastic changes on the one hand and the desire to be supporters of "traditional values" on the other in the face of entrenched public expectations. In addition, the resolution of today's crisis involves a far more complex international dimension. Tensions arise between the need to take a globally coordinated and consistent policy approach and the desire to address the concerns of domestic voters. It may be tempting to blame other countries for domestic problems and take unilateral actions at a time when international coordination is indispensable. While the collaborative approach is being actively pursued in the G-20, the European Union, the Financial Stability Board and various international bodies, there are also many policy actions being taken or proposed that have not fully taken account of broader international implications.

The third aspect is that the conflict between policy objectives is becoming more evident and acute, often polarizing politics and creating gridlock and further delaying needed actions. Ideologies have become more important in the political arena than pragmatism. The policies, which moderate and centrist voters think are necessary and acceptable, are becoming politically unpopular because of the stronger political appeal to take extreme positions. The ability to foster compromise and carry forward the needed policy, which is most needed in such a moment, is undervalued in the age of sound bites and in the face of frustrated voters. This is particularly acute on the fiscal policy side; any retrenchment in fiscal spending or tax increase has been fiercely resisted in the name of supporting the economy, regardless of the seriousness of the fiscal situation. While fiscal stimulus to support the economy can play an important role under normal circumstances, the effects of fiscal stimulus would be diminished when fiscal deficits are beyond a certain threshold as longer-term fiscal sustainability becomes threatened and public anxieties increase.

Are the Markets to Blame?

One of the most difficult challenges today is to embrace the merit of open and vibrant markets. Against the backdrop of the frustrating pace of the economic recovery, markets have been increasingly blamed for the problems created. Combined with the perceived problems of corporate governance in the financial industry, public confidence in financial markets seems especially eroded in many developed countries. In countries where public funds were used to deal with the critical crisis situation, criticism has become particularly harsh and hostile toward policies to enhance the role of market mechanisms. Efficient, transparent and open capital markets, which have long been accepted as an indispensable engine for economic growth and development, are now viewed with a measure of skepticism. While the criticism toward market systems may be exaggerated in many instances, the anxieties and uncertainties are real and cannot easily be dispelled over a short span of a few years, particularly for the deeply affected segments of the population.

Is it right then to blame the market-based system? Markets may often turn out to be irrational, but no alternative systems have ever come to exist that could play the role of efficiently allocating scarce capital. Under the market based system, investors who make poor decisions suffer quickly and those who take contrarian risks contribute to dampening excess in the markets. The market based financial system itself has mostly functioned effectively and allowed for a much quicker resolution of problems and resumption of normalcy than the bank-based system. One can argue that without the market-based system, the recent problem could have been much worse and the adverse impact much larger.

It is particularly important to distinguish between the role of the market system and the abuse of the system by market participants. Episodes of abuse of the markets, which often tend to surface in the aftermath of financial crises, exert powerful impact on public opinions and policymakers. However, the existence of the episodes of abuses itself is not necessarily a sign of weakness in the system. Rather, early and effective detection of abuses is a sign of strength of the system. These episodes could have been prevented if rules had been clearer and enforcement had been more effective. There is always room for improving regulation. The initiatives to improve them should be taken forcefully. These improvements are in fact mostly on the side of enhancing the role of markets rather than on the side of reducing it.

Japan's "Lost Decade" and "Déjà Vu"?

In the wake of the financial crisis, the motto worldwide was to avoid Japan's perceived mistake, the "Lost Decade"—the vicious deflationary trap of prolonged stagnation. Four years after the global financial crisis, it is worth asking ourselves if the world economy has succeeded in avoiding the Japanese experience and, if so, in what sense.

In the first place, it is useful to ask if and in what sense the past decade was "lost." It is true that for more than a decade the nominal and real GDP growth was low and often in the negative in Japan after its financial crisis. Deflationary pressures persisted and the stock market performance was lackluster. Fiscal deficits ballooned. Demographic problems became acute, with a declining birth rate. The Japanese yen appreciated significantly as a result of the changes in the relative stance of monetary policies, adversely affecting the competitiveness and continuously exerting deflationary pressures. But the unemployment rate stayed at a relatively low level by international standards. Many corporations are sustaining investment and taking international opportunities offered by strong growth in the region. While there have been major setbacks from the earthquake and tsunami of March 2011, the manufacturing sectors have recovered from the damage quickly, showing resilience and willingness to overcome the difficulties.

Importantly, this resilience has been supported by many reforms that were undertaken to strengthen market mechanisms and modernize the financial sector, opening up the markets, encouraging competition and upholding international standards. In fact, in terms of policymaking, the "Lost Decade" was not really a lost one, but rather a decade of substantial reform of Japan's financial and economic systems. Since Japan launched its "Big Bang" in financial reform in late 1990s, initiatives were launched to make Japan's financial system more open and competitive in international finance. Japan has embraced the standards and codes promulgated by international groups and institutions, including the Basel Committee. In light of accelerating integration of financial markets, Japan's reform of accounting and auditing standards has also been advanced in light of the ongoing of global convergence. These reform efforts were undertaken in earnest when banks were struggling to deal with non-performing loans. A permanent safety-net deposit insurance system was also put in place, which can be activated to inject public funds to capitalize failing banks or nationalize them if systemic risk is detected. These reforms also created dynamism, contributing to structural changes in the Japanese economy and corporate governance. Cross shareholdings were unwound and international investors now hold about 27 percent of shares issued by listed Japanese companies. Labor mobility increased. During the process, foreign financial institutions operating in Tokyo also enhanced their role, contributing to a deepening in the markets and diversifying financial services. As a result, the Japanese financial system has become more robust and Tokyo's financial market has become one of the most open and vibrant markets in the world.

Why then is there this perception of the "Lost Decade" in Japan? It is probably more to do with appearance than to reality. It is also related to the perception of policy stalemate that has often persisted. The process of reform and transformation is long and painful. Japan has been going through major changes affecting many segments of society. It is not difficult to detect the ambivalence toward reform that has been created in the aftermath of the crisis. The mood of the public has become wary and less forward-looking. Political debate becomes driven less by reality but by nostalgia.

When the global financial crisis erupted, many in Japan felt a sense of "déjà-vu". This may also have reinforced anxieties and bred a degree of complacency. What seemed to be the weakness in Japan's financial system has proved to be much more universal this time around. The series of difficulties faced by the United States and European financial institutions seemed similar to what Japan saw a decade ago. The ensuing policy responses also looked strikingly alike: aggressive injection of liquidity into the money market by central banks and the lowering of interest rates—effectively to almost zero interest rates—and capitalization of banks and liquidity injection. The short-selling in stock markets was restricted, particularly for financial sector shares. In the days when Japan's previous crisis was at its height, the economy was portrayed as a unique and opaque form of capitalism and some of these policy actions, including restricting short-selling, were criticized as heavy-handed or excessively interventionist. But these are now more prevalently used to prevent market abuses. Having gone through these humbling and agonizing processes on the one hand and witnessing the parallels between Japan's crisis and the subsequent global crisis, the Japanese public may therefore have strengthened their ambivalence toward reform. Difficult decisions, particularly in the area of tax and social security reform to ensure fiscal sustainability, have been postponed and exacerbated problems, although the current account surplus has masked them.

Certainly, more needs to be done to make the Japanese economy competitive and dynamic. This should mainly come from revitalizing market forces by increasing transparency, encouraging risk taking and entrepreneurship by focusing on long-term investment in education and research. The process of reform is ongoing and is far from complete. The Japanese economy needs to be more globally oriented as well in order to reap the benefits of rapid integration of world economy and dynamic growth of emerging markets, particularly in Asia. The banking sector and the financial sector also need reform to better serve the economy by embracing globalization and regional economic integration. Such reforms will continue to entail anxieties. Fortunately, however, the global reform initiatives are perfectly in line with the reforms that had already been embarked on. Japan should feel confident in continuing to pursue these goals proactively and forcefully.

A Balanced Approach

Financial crises require similar solutions. It is the complexity, scale and political situations that differ in each crisis. In the aftermath of the crisis, the political situation may easily turn into polarization and stalemate, particularly in open and democratic countries. Whether the world economy has succeeded in avoiding the "Lost Decade" remains an open question, especially if the reform entails long-term difficulties and political stalemate becomes persistent in many countries. The overhang of public sector debt makes people ambivalent and less forward-looking. What Japan's experience can offer is not really what should be or should not be done in terms of policy recommendations, but rather a sense of realism and difficulty of policy implementation. The solution requires political leaders to refrain from polarization and to stay balanced. The stalemate from political polarization is the real problem that can prolong the difficulties, which should be avoided in all cases.