

Fallout of the Miracle

Don Chaplin
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Table of Contents

Introduction	page 2
Traditional Japanese Growth	page 3
Why Japan's Growth has stopped	page 6
Current Macroeconomic Problems	page 11
Political Problems and the Government's proposed reforms	page 12
Recommendations for Reform	page 15
Conclusion	page 18
End Notes	page 20
Bibliography	page 21

Fallout of the Miracle – Japan’s Current Economic Crisis

Don Chaplin

Introduction

Only a few years ago Japan was viewed as an exemplary economic success story and a model of prosperous economic long-run growth. Analysts talked of “Japan Inc.” and the Japanese growth model was being suggested as a case study to be followed by other developing and developed countries. Conversely, the United States (U.S.), economy at the end of the 1980’s was affected by a serious malaise. The problems included: low growth of Gross Domestic Product, a sharp recession in 1990-91, large trade imbalances, a weak dollar, a hollowing out of the manufacturing sector, and persistent speculation of a structural decline of U.S. power. The book by Yale historian Paul Kennedy, “The Rise and Fall of the Great Powers”, touched a raw nerve in the U.S. by suggesting that political and strategic decline was historically caused by economic mismanagement and poor economic performance.¹

Today, the situation for both nations appears to have completely reversed. Serious economic recession and turmoil has plagued Japan, while the U.S. economy has become “lean and mean”. Because of a dramatic restructuring process and competitive resurgence, the U.S. economy is now highly productive, extremely innovative, and very competitive in world markets. The U.S. is ranked fourth in competitiveness according to the recent “World Competitiveness Report”, while Japan has slipped to thirteenth.

One must admit that if a few years ago the success of the Japan economic model was being hyped too much and the weakness of the U.S. economy exaggerated, it is likely that now the inefficiency of the Japanese economy might now be exaggerated as well. However, I will argue that the Japanese economy suffers of severe problems that are not only cyclical but more structural in nature. Such structural problems are the most serious impediments to entrepreneurship, economic dynamism, innovation, and the future long-run economic success of Japan.

Traditional Japanese Growth

Japan suffered extensive damage in World War II. Subsequently, the country undertook a reconstruction that resulted in a complete modernization of its manufacturing facilities. Japan's economy expanded rapidly from the mid-1950's through the 1960's, experiencing only two short recessions, in 1962 and 1965. The annual growth rate averaged close to 11% in real terms for the decade of the 1960's. This compared with 4.6% for the Federal Republic of Germany and 4.3% for the United States in the period from 1960 to 1972, and it was well above Japan's own average prewar growth rate of about 4% a year.²

It is generally agreed that the rapid expansion of Japan's economy from the late 1950's through the 1960's was powered by the vigorous investment of private industry in new plant and equipment. The high level of savings of Japanese households provided banks and other financial institutions with ample funds for heavy investment in the private sector. The upsurge in capital spending was associated with the introduction of new technology, often under license from foreign companies. Investment for

modernization made Japanese industries more competitive on the world market, created new products, and brought Japanese enterprises the benefits of mass production and improved productivity per worker.

Another factor behind Japan's economic growth during this period was the availability of an abundant labor force with a high level of education. Reasonably large numbers of young people entered the labor force every year, and there was also a heavy migration of agricultural workers to manufacturing and service jobs located mostly in the larger cities.

As best exemplified in the 10-year Income-Doubling Plan announced in 1960, the Government's economic policies at the time aimed to encourage savings, stimulate investment, protect growth industries, and promote exports. Japan benefited from an expansionary world economic climate and the availability of an abundant supply of relatively cheap energy from abroad throughout this period.

After a short recession in 1965, the Japanese economy enjoyed a long period of prosperity until 1970, with the real growth rate during this period averaging close to 12%. The main factor behind this growth was rising capital investment, used for major outlays designed to bring about economies of scale, build additional facilities to increase export capacity, and acquire equipment needed to respond to changes in the economic and social environments, such as labor-saving tools and pollution-cutting devices. Increases in exports due to the stronger price competitiveness of Japanese products also supported the sustained rise in business activity, leading many economic analysts to call the Japanese economic resurgence a "miracle". During this period, most industry was organized into

“keiretsu”, a group of affiliated companies formed around one of the three major Japanese banks.³

Japan was able to experience such dynamic growth because of the Japanese peoples’ underlying value system. The average Japanese citizen had the characteristics of valuing social cohesion and collective goals over individualistic pursuits of personal welfare. The Japanese citizen was also conservatively risk averse versus aggressively risk-taking. Japan also was successful because it had an economic system based on limited market competition and oligopolistic market structures with a strong amount of regulation and government intervention in the markets. In addition, Japan had established a protectionist trade regime, emphasizing exports over imports and restricting the amount of inward foreign-direct-investment.

The Japanese culture also supported Japan’s success. A system of life-time job security had been established as well as implicit and explicit systems of social insurance for firms and households to address and support the overall risk-aversion behavior of the Japanese culture. To ensure the risk-aversion behavior of its citizen’s, the Japanese educational system was forged on the premise of emphasizing traditional values over innovation and individual creativity. Japanese industry also spurred the growth of the 1950’s-1980’s by establishing a research and development model based on “process innovation” rather than “product innovation”. This means that the typical Japanese firm would concentrate on the quality improvement of an existing good rather than the creation of a new good.⁴

Why Japan's Growth has stopped

With such a strong growth record from the 1950's through the 1980's and a solid social and economic base, it is difficult to conceive of many problems that could have a long-term detrimental effect on Japan. But in the 1990's Japan has experienced many of these previously unimaginable problems. The crucial question for Japan then becomes: is the experience of the 1990's just a temporary and cyclical negative adjustment that does not call in to question the traditional Japanese growth model, or is the traditional economic regime now partially flawed and in need of structural change and reform?

I will argue the latter case because many variables have changed over the decade, making the old growth model obsolete. Numerous analysts have advanced the hypothesis that higher growth in the new global economy is associated with the greater risk-taking, dynamic entrepreneurship and more aggressive competition rather than the low risk models of the previous decades. Therefore, the old growth model does not work anymore because of four fundamental new trends in the global economy.

The first major trend in the global economy is the structural change in the nature of technological innovation. From the 1940's to the early 1980's, innovation took the forms of already existing technologies and goods that had to be improved in quality, such as cars, stereo systems, and photographic equipment. The Japanese were the best at taking an existing product and improving it either through "process cycle innovation", "quality improvement", and "product imitation". Therefore, the Japanese prospered during this time period because they were able to profit from product improvement, while

avoiding the expensive and time consuming phases of product research and development.⁵

Today, technological innovation is very different because of qualitative changes in technologies and the rapid appearance of new and diverse products. These new products include: computers, software, information technologies, the Internet, telecommunication services, and new financial instruments and services. These products are appearing and changing at such a rapid pace that an imitator cannot catch up with the technological leaders. The production cycle of innovation has become drastically shorter, giving an imitator even less time to make improvements on an existing product. This has eliminated Japan's traditional role in product/production cycle improvement, because by the time that a Japanese firm has found a way to make an existing product cheaper or better, the product is already obsolete and has been replaced by a newer product from a technological leader. In today's global economy a firm must either innovate and remain on the cutting edge of the technological wave or it will remain forever behind. A recent *Wall Street Journal* editorial piece offered a very harsh but common expression of the current U.S. views of Japan, "After having spanned a cottage industry of books on how Japan would "take over the world", Japan now leads in few if any of the important industries of the 21st century."⁶ While such a view might be particularly severe in several respects, it conveys the perceived American reversal of fortunes in the contest about the correct model of economic growth.

The second major trend that has impeded Japan's growth is greater global trade competition. Increased global trade has led to global competition and the need for industrial restructuring. Japan has not liberalized its trade and has delayed all structural

adjustments. The strong Yen trend until 1994 led to significant import penetration and loss of domestic manufacturing jobs. This took place because the expensive Yen made it economical for Japanese consumers to purchase a cheaper foreign substitute for a traditionally domestically produced good, thereby depriving domestic industry of revenue and supporting foreign competition and penetration.

The significant fall of the Yen since 1995 has provided some short-term revenue for the battered Japanese manufacturing sector because its' goods are cheaper relative to foreign goods, thus fueling domestic demand. However, in the long run this will not aid Japan because it dilutes the incentives for necessary structural re-engineering and significantly slows the drive to change and adapt to the trends of the 21st century. Also, the regulated and non-competitive sectors of the economy, such as agriculture, have not been affected by the external environment and have received much less pressure to change from their respective status quo's.⁷

Yet another problem that Japan faces from global competition is restrictions in foreign markets. Japan was famous for protecting their domestic industries and markets from the 1950'-late 80's. Today, this has reversed because many large trading markets, such as the European Union and South America have placed restrictions on the amount of Japanese imports that they will accept. The European Union has been particularly strict in creating trade barriers with Japan because it wants to avoid a common Japanese practice of "dumping" in the European Union. Dumping is a competitive pricing maneuver in which a large firm prices their good below cost in an effort to discourage any new firms from entering the market and to bankrupt any other existing firms because the good cannot be sold for a profit. Once all other competition has left the market, the

remaining firm than charges extravagantly high prices in an effort to recoup the loss that it suffered from dumping. The European Union, in an effort to avoid Japanese dumping, has required numerous Japanese firms to first agree to sell their products at a price not lower than the domestic equivalent, before the Japanese firm is allowed into the European Union market.⁸ This has been disastrous to Japanese firms because they can no longer compete on price, their traditional strong niche, and now must compete on other platforms.

A third trend that Japan has failed to follow is increased deregulation to foster competition. Since the early 1980's the U.S. has experienced a major process of economic "deregulation" in numerous sectors of the economy, including manufacturing goods, services, traded and non-traded goods. Such policies of deregulation have led to competition, pursuit of efficiency and major economic restructuring. While there is currently a great deal of discussion and policy proposals for major deregulation of the economy in Japan, this has not yet occurred on any significant scale.

It will be difficult to institute deregulation in Japan because deregulation will have negative short-term effects on the Japanese economy, with the negative effects being predominately an increase in unemployment for Japanese workers, as foreign firms are allowed to provide services once only provided domestically. Therefore, many analysts feel that because of its negative short-term implications for employment, further deregulation is not appropriate now. The prevailing attitude is that Japan must first deal with the financial sector's troubles and with fiscal stimulus. Then, in a year or so, when the real economy is expected to be healthier, an invigorated drive for deregulation can be launched.

However, once deregulation is enacted and the long-term ramifications are felt, Japanese firms will be forced to pay much closer attention to profitability and the return on capital, a focus that in turn, will drive corporate restructuring. Deregulation also will provide profitable opportunities for foreign financial services providers. Their expanding market presence will reinforce incentives to restructure.

The final major global trend that Japan has failed to adapt to is corporate restructuring of existing firms and industries. The combined forces of technological change, trade competition and deregulation of the economy led to major corporate restructuring in the U.S. in the 1980's and 1990's. The restructuring in the U.S. primarily took the forms of: re-engineering, out-sourcing, downsizing, and the merger and acquisition of one firm by another. Because of the dramatic restructuring in the U.S. over the last two decades, the U.S. economy is now highly productive, highly innovative and extremely competitive in world markets. Corporate restructuring has prepared the U.S. for the 21st century global economy.

Japan, on the other hand, has failed to undergo the necessary changes of corporate restructuring, thus impeding any progress that could be made towards joining the new world economy. Instead, the strong Yen of the early 1990's led to outward foreign-direct-investment, the hollowing out of the manufacturing sector, and significant job losses but no major structural reform. Reform in Japan has been very slow because of the following factors: the lack of deregulation, the persistency of oligopolistic structures, the lack of market competition, protective trade policies and practices, and the weakness of the Yen. While these factors have sheltered Japan in the short-run from the brutal logic of the new world economy, they have also significantly slowed the pressures to reform.

Thus in the long-run, Japan might be much worse off for delaying the needed structural reforms of the economy. Therefore, the de-industrialization and general decline of Japan will grow exponentially as more and more time passes without corporate restructuring.⁹

In the view of Stephen Roach, an influential Wall Street analyst who has studied the U.S. restructuring over the past decade, “The road to Japanese competitive revival is going to be a lot longer and more arduous than which the U.S. has traveled since the early 1980’s.”¹⁰ The different social culture and history of Japan suggest that Japan will not and should not follow the American model of reform. However, there is need for major reform and delaying these reforms will not help Japan because ignoring short-run pain might lead to more serious problems in the long-run, as the persistence of the current recession for over seven years now suggests.

Current Macroeconomic Problems

Over the past seven years, Japan has suffered from a plethora of macroeconomic problems. There are four major areas of concern for Japan’s macroeconomy: serious fiscal problems, poor growth, weak labor market conditions, and the East Asian financial crisis.

Fiscal policy was strongly contractionary in 1998, with an increase in consumption taxes, ending of a temporary income tax cut, and a sharp decline in public investment. This led to a one and a half percent point reduction in the deficit, but caused higher public debt because Japanese citizens were no longer receiving any income tax reductions, while at the same time being forced to pay out more for increased consumption taxes on various goods.¹¹ This has left the Japanese citizen with less disposable income, as evidenced by the sharp decline in public investment.

The Gross Domestic Product (GDP) of Japan has suffered intensely over the past seven years. The growth rate of the GDP was close to zero on average from 1992 through 1996 and has declined in both 1997 and 1998, meaning that Japan faces major problems because the economic output of Japan has actually become smaller the past two years.¹²

Weak labor market conditions are making it extremely difficult for Japanese citizens to find and hold quality jobs. Employment growth has stagnated over the past six years and there is serious employment uncertainty in today's job market. This is exemplified by the high unemployment rate of 3.3% in 1998, which is high for Japanese standards.

The East Asian crisis will affect Japan more than other industrialized countries because of Japan's strong trade linkages and large volume of lending to the East Asian region. This will in turn affect the financial sector, because of the large amounts of loans the Japanese banks have made to East Asia. Two major Japanese banks already failed in 1997 as the strains of the crisis intensified.

Political Problems and the Governments proposed reforms

The Japanese political system has severely hindered Japan's economic recovery. The Liberal Democratic Party dominated the Japanese political system from the post WWII period until 1993. During this time the LDP supported the protection and subsidization of certain industries in exchange for political patronage. However, the protected industries are seriously hampering Japan's ability to prosper in the global economy.

Today, Japan is being torn between two different agendas. Strong, competitive, and innovative companies, including Toyota, Sony, and NEC, call for greater openness and more deregulation, while weak, heavily protected sectors, like construction and agriculture, demand increased protection from the government. This has caused a heated confrontation between the "progressive" force that demands drastic change and structural reform of the existing system, and its countervailing "conservative" force that requires protection, and therefore opposes any drastic reforms.

The Japanese political system can do nothing but vacillate between these two conflicting forces in the society. "Politics as usual" lags far behind economic reality. The vacillation of political leadership has caused Japan to suffer tremendously over the past seven years. The Tokyo stock market has lost approximately two-thirds of its 1989 value, while growth rates have averaged under 1.4% from 1992 to 1997 and were actually negative in 1997 and 1998.¹³

Despite the fundamental shift in economy in the 1990s, the Japanese policymakers still maintain the mindset from the period of high economic growth of the 1970s and 1980s. At that time, they expected an expanding economy to solve most of the economic and social problems. Therefore, the primary task of politicians was to distribute the ever-increasing national income, which they channeled back to their local patrons. Their typical tool was a stimulus package, which was funded by an immense pool of savings.

Little has changed. Since fiscal year 1993, the government has implemented a series of anti-recessionary packages providing over 60 trillion yen (\$480 billion) in stimulus. Most of the money has gone into public works and residential construction. As

a result, the number of businesses in the construction industry has risen by 30,000. It is important to note that during this same period, manufacturing companies have been restructuring their operations and sharply cutting their payrolls in order to survive against international competition. The agricultural and financial sectors, which along with construction provide the dominant LDP with a solid support base, have managed to remain immune from foreign competition.

Recently, Japanese politicians announced that they will not let any other major Japanese financial firms go bankrupt after the failures of Hokkaido Takushoku Bank and Yamaichi Securities in November 1997, suggesting that they still believe in protecting poor performing sectors from natural market forces.¹⁴

This announcement, coupled with the LDP's refusal to alter the biased savings program, confirms that the Japanese political system is still a strong counter-force against reform. Instead, the political system has agreed to take a gradual and incremental approach to reform because they do not want to alienate any of the conservative sectors which fund and support them.

The proposed reforms include measures to restore financial system, implementing economic stimulus packages, and promotion of Japan's economic structural reforms.

The main pillars of financial system reform are: stronger bank supervision, accelerated disposal of bad loans and early restructuring of viable financial institutions. These plans are currently under intense debate in the Diet and are expected to be passed into legislation by July 1999.

The Japanese Government introduced the largest ever package of emergency economic measures, 16 trillion yen (US\$ 119 billion), in April 1998. A supplementary

budget was then passed in June. The combined effect of these measures, together with implementation of the fiscal year (FY) 1998 budget, should soon start to strengthen economic recovery. The Cabinet will support this by initiating new and permanent corporate and income tax cuts worth well over six trillion yen (US\$ 44 billion). In addition to these tax system reforms, a second supplementary budget of more than 10 trillion yen (US\$74 billion), will be created in an effort to set the economy back on the road to recovery by reviving domestic demand.

The third aspect the Japanese Government will introduce is the promotion of Japan's economic structural reforms. In November 1998, Prime Minister Obuchi established a plan to double living space, including measures to expand high quality residential space, office space and recreation space. The aim is to dispel the psychological uncertainty of the Japanese people, one cause of Japan's current consumption slump, by clarifying the direction of Japanese public and private investment, thus setting the economy on a path toward domestic demand-led recovery. Prime Minister Obuchi's next step will be to develop and implement a more comprehensive plan, which includes infrastructure development, sweeping deregulation and tax system support.¹⁵

Recommendations for Reform

Clearly, something has gone wrong in Japan. Analysts, both from within and outside Japan's borders have offered many combinations of economic diagnosis and policy prescriptions. I will attempt to summarize the most common and economically sensible strategies in the remainder of this section. The recommendations have been

divided into: fiscal expansion, monetary stabilization, financial reform, administrative and political reform, and educational reform.

Fiscal expansion must be focused on changing Japanese savers' and investors' confidence, both by restoring expectations of above-potential growth and price stability and by removing the incentives to excessive saving. There must be a fiscal stimulus of 4 percent of GDP before the end of 1999. Unless the economy is stimulated above potential growth of 2 to 2.5 percent per year, unemployment will continue to rise. Confidence, and with it consumption and investment, will erode further. A small fiscal-stimulus package may, therefore, be a waste of money, whereas a sufficiently large fiscal package will lead to sustained growth.¹⁶

Permanent tax cuts must also be incorporated into the fiscal stimulus plan. Permanent tax cuts are more likely than temporary cuts to be spent and to affect consumer planning. Income-tax cuts are better than consumption-tax cuts because income-tax cuts get money directly to the Japanese citizens. Tax cuts reduce distortions in the economy, induce future cuts in public spending, go beyond specific politically favored sectors, and provide a clear signal of commitment from the government. The tax cut deficit can be funded with short-term government debt.

The second phase of the program is monetary stabilization of price expectations against both deflation and inflation. For Japanese citizens to spend and Japanese businesses to invest they need faith in the stability of the purchasing power of their currency. This is necessary for any lasting revival of Japanese asset prices.

The Bank of Japan, therefore, should announce an inflation target of 3 percent for FY 2000.¹⁷ Deflation is clearly harmful, especially when debt is held by a fragile financial system, such as Japan's current situation.

The depreciation of the Yen must also be avoided. A decline in the value of the Yen increases uncertainty and erodes wealth. Such loss of purchasing power encourages people to take money out of the economy and deters investment. More so than inflation expectations, movements in exchange rates can spiral beyond the intended push. In addition, depreciation is less effective in stimulating the economy than are domestic policies, because a depreciation's benefits are concentrated in particular export-oriented sectors. Depreciation also risks a competitive devaluation response by other countries and a protectionist response to further increases in Japan's trade surplus.

The third area is financial reform. The cleanup should follow prior banking-system cleanups in the United States and other economies in the 1980's and 1990's. At a bank closing in the near future, clarify the extent of deposit guarantees by directly paying off individual account holders to the limit of the guarantee, but no higher. New capital must be placed only into solvent banks, and cutoff the moral-hazard-driven overlending of those banks that have zero or negative net worth. There must also be a creation of an independent institution similar to the U.S. Securities and Exchange Commission to improve disclosure procedures and expand shareholder rights.

The power of the bureaucracy and special interests groups must be reduced if Japan as a whole is to prosper in the 21st century. Currently, it is special interest groups that are refusing to allow the necessary changes of deregulation and financial market liberalization to take place because foreign competition would be disastrous for the

special interest groups. The power of the bureaucracy can be diminished by dismantling the Ministry of Finance and the Ministry of International Trade and Industry into several smaller agencies and eliminating non-essential departments of those agencies. There must also be the regional decentralization of power to reduce central power.

Educational reform is extremely important for Japan to make true gains in the global economic world. Instead of imitating successful products and ideas, Japan must foster basic research and creativity in its' children. By supporting innovation and talent, future Japanese citizens will have the confidence to use their own best judgement and avoid the current situations of moral hazard and blindly following the status quo.

Conclusion

For seven years, Japan's bureaucrats have been wrestling with market forces, trying to force them into submission. But Japan's slide into recession has only intensified over this time period and the bureaucracy must now learn that they are at the mercy of the world markets. The world market has become too large and global for the Japanese bureaucracy to manage it. "This is the revolt of the market against the government," Takeshi Sasaki, a political scientist at Tokyo University, said of Japan's crisis.¹⁸

Will Japan be successful in radically altering its' bureaucracy to meet the changing global market? There are reasons for both optimism and pessimism. On the negative side, the Yen is now weak, which delays incentives to reform because Japan's goods are cheaper relative to foreign goods, thus fueling domestic demand. However, in the long run this will not aid Japan because it dilutes the incentives for necessary structural re-engineering and significantly slows the drive to change and adapt

to the trends of the 21st century. Another pessimistic argument is the large Japanese corporations, (Sony, Honda, Mitsubishi, etc.) are now multi-national corporations and their fortunes depend less on the success of the Japanese economy. Therefore, they have less incentive to lobby with the bureaucracy for change because they have less at stake in Japan. Additionally, Japan has only reformed after a major crisis in the past. While the Japanese crisis is intensifying rapidly, there has not yet been the significant climax of the crisis that would break the deadlock in favor of reform.

On the other side, there are reasons for an optimistic outlook on Japan's future. As evidenced by the Meiji Restoration and the Post-World War II development, Japan has historically been able to rapidly reform and adapt in periods of crisis, when the reformation is fully supported by the government. Also there is significant and growing pressure from the business and urban sectors to reform. The government under Prime Minister Obuchi is beginning to recognize that a problem does exist and is altering policy and programs to adapt to the crisis. This is demonstrated by the proposed government reforms including: measures to restore financial system, implementation of economic stimulus packages, and the promotion of Japan's economic structural reforms. Perhaps of most importance to the future of Japan, is the Japanese people's culture. The Japanese have repeatedly shown to be hard working, creative, willing to sacrifice personal interest for the collective good, and willing to respond to challenges. These characteristics and qualities will be a great asset for Japan as it prepares to fight its way back to the top of the global economy and regain the economic dominance that it has become so familiar with.

End Notes

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- ¹ Hollerman, L.
 - ² Japanese Economic Study Agency
 - ³ Kodansha encyclopedia of Japan, pg.130
 - ⁴ IBIT, pg. 132
 - ⁵ Dornbusch, R. pg.12
 - ⁶ Schlesinger, J.
 - ⁷ Wolf, M.
 - ⁸ Daiwa Institute of Research
 - ⁹ Japan Information Network
 - ¹⁰ Schlesinger, J.
 - ¹¹ Krugman, P.
 - ¹² Japanese Macro-Economic Data in BCI Format
 - ¹³ Japan Window
 - ¹⁴ Japan Institute of Policy research
 - ¹⁵ Ministry of Foreign Affairs
 - ¹⁶ Japanese Economic Study Agency
 - ¹⁷ IBIT
 - ¹⁸ Samuelson, P.

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