
THE STORY OF

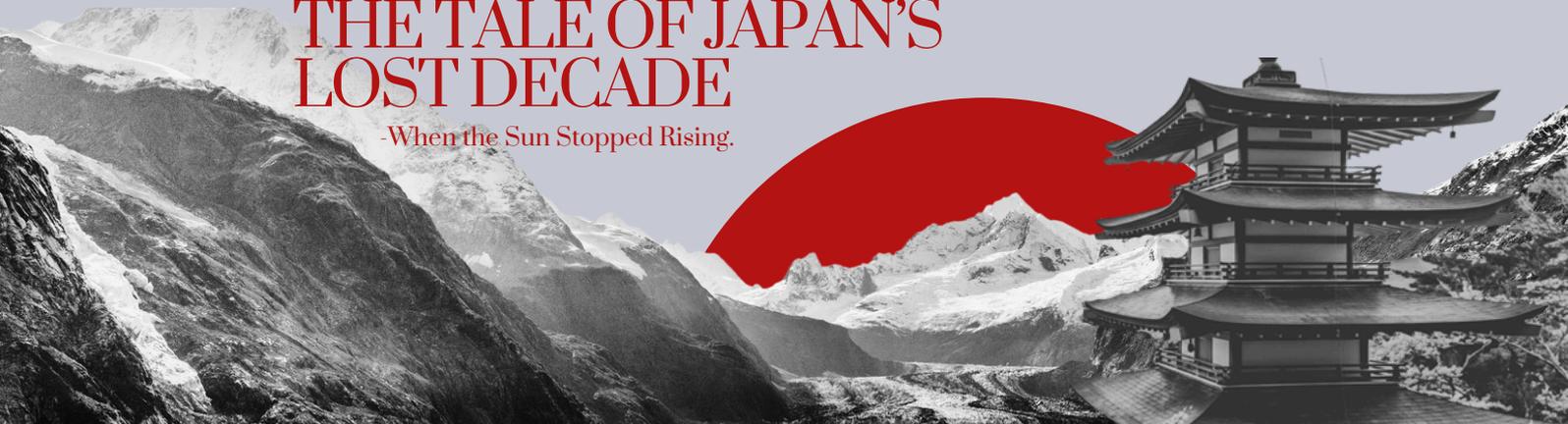
JAPAN'S LOST DECADE

When Delayed Decisions Turned a
Slowdown into a Lost Decade!



THE TALE OF JAPAN'S LOST DECADE

-When the Sun Stopped Rising.



At the peak of Japan's boom in December 1989, Tokyo's real estate market had reached a level of madness that is still hard to believe today. Theoretically, it was said that a single square kilometer of land in the heart of Tokyo, that is the Imperial Palace, was worth more than the entire state of California. The stock index was seen as a vertical line on the chart, climbing towards a peak that investors believed was a permanent new plateau. It didn't feel like a bubble. Instead, it was hailed as a Japanese miracle. But every ascent has its limit. To understand how this golden era of boundless confidence dissolved into years of stagnation, we need to travel back in the 1980s.

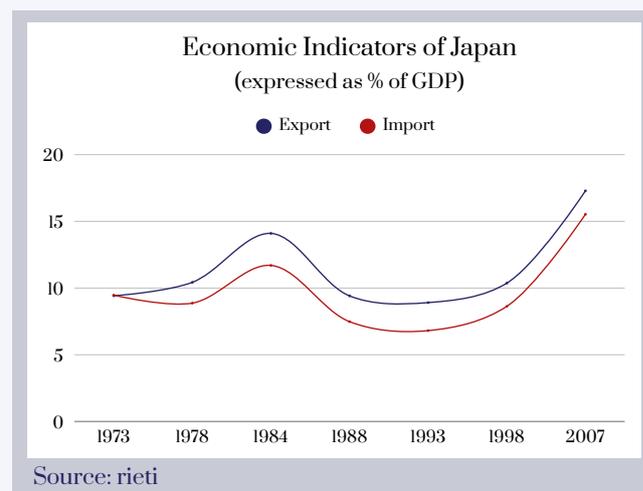
JAPANESE ECONOMIC MIRACLE

Just as China is viewed today, Japan was nearly unstoppable in the 1980s, as it was the second-largest growing economy in the world. Similar to China's current push to maintain growth rates of 6-7%, Japan was also growing at a rate of 4% annually. Over the decade, Japan not only grew domestically but also had international demand. This demand fueled its growth and led to a negligible rate of unemployment and easy access to credit. Because of this, many people in Japan believed that they had cracked the code of permanent prosperity, and this period came to be known as the "Japanese Economic Miracle".

THE CATALYST

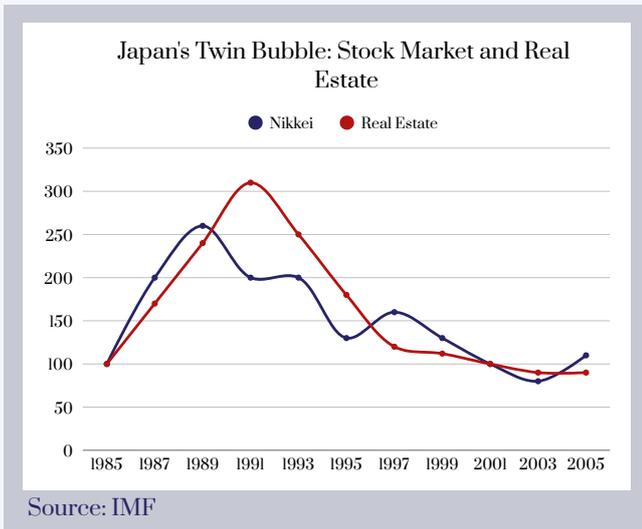
When everything was going well in Japan, the story took a U-turn. In 1985, Japan, along with other G5 nations, entered into an agreement called "The Plaza Accord". It was basically aimed at resolving its trade imbalances with fellow G5 nations, and it led to an immediate revaluation of the Japanese yen. This meant allowing the yen to rise sharply. Now, the appreciation of the Japanese currency made the exports more expensive, threatening the very engine that powered its growth. Later on, a similar pattern was seen in the Chinese yuan, facing comparable

pressures and fluctuations driven by policy responses. But the Chinese authorities actively intervened in the foreign exchange market to curb the appreciation of the yuan. The central bank bought foreign currency to stabilize the exchange rate, and this led to an expansion of liquidity within the domestic economy. Eventually, the Chinese authorities were able to control the situation and did not make it worse.



However, Japan failed to do so. This appreciation of the Japanese yen created a situation of panic, and as a result, the Bank of Japan found itself trapped. It had only two options. If it tried to protect its exporters by keeping money cheap, this risked overheating an economy that was already inflated. And if it tightened the policy, it risked the growth of Japan's economy. Facing this trade-off, the central bank chose the safer option. The Bank of Japan cut the interest rates and kept them low for years, flooding the economy with easy money.

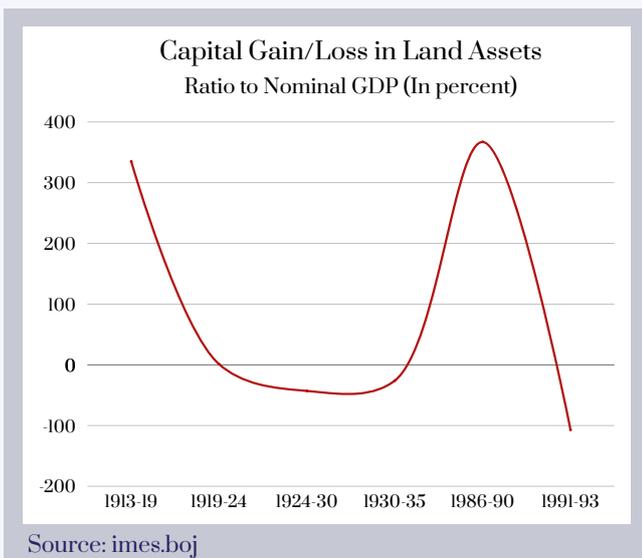
The sudden rush of this "easy money" ignited speculation by both corporations and, later on, households. This resulted in the formation of the "Twin Bubble" in the stock and real estate markets. Between 1985 and 1990, land and real estate prices rose by over 167%. Land prices were rising so rapidly that simply owning land became more profitable than putting it to productive use. Whereas, the stock prices doubled.



THE BUBBLE BURST (1989-1991)

By 1989, the Bank of Japan realised the threat of this asset inflation on the economy and tried to control the situation by raising the interest rates five times sharply and repeatedly between 1989 and 1991 over a very short span. This decision worsened the whole situation, and the aftereffect was brutal. As a result, the Nikkei Stock Index, which had climbed close to 40,000 points in late 1989, collapsed by roughly 50% within two years and was below 20,000 points by 1992.

The land and real estate prices were rising rapidly which made banks assume that the land prices would continue to rise. Consequently, the banks started extending credit on this new and inflated land rather than on the borrower's ability to generate cash flow, and this led to the situation of The Valuation Trap.



Later on, the bubble burst showed its most devastating effects in 1991, wherein the rate of business bankruptcies rose by around 66% and wages of workers decreased massively, while unemployment remained low. The projects of factories, real estate projects, and other heavy capital investments remained unfinished, and the period of the lost decade was finally in full swing.

THE FALSE RECOVERY

The burst of the twin bubbles majorly interrupted Japan's period of economic miracle. Its economy transitioned from a high-growth one to a period of stagnation. It was growing only about 1% around the mid-1990s, unemployment rose slightly, inflation fell by about 3.5%, credit continued to flow, and the bank's bad loans were also manageable. Now, because the damage seemed very limited, the policymakers assumed that the situation was like a normal business-cycle slowdown, and the economy would be able to correct itself without the need for aggressive policy action.

This made the government adopt a policy of Regulatory Forbearance, allowing banks to delay recognising losses on bad loans in the hope that a market recovery would restore their solvency. At this very moment, authorities and regulators did not understand how bad the problem of bad loans was and hoped that the economy would recover on its own. They tried to keep the economy working by injecting money and spending heavily, but this did not solve the actual issue because banks were already struggling with the problem of non-performing loans (NPLs). They held back money when the government spent heavily, instead of lending money forward. And because of this, the actual purpose of government spending could not be fulfilled.

This delay in recognising these losses cost a lot to both the taxpayers, as their funds were also deteriorating, and the government, which was continuously building insolvent zombie firms. Zombie firms here are the companies that were on the verge of bankruptcy but were kept alive through consistent bank and government support instead of being closed or resolved.

For a brief moment, this optimism was justified, as between 1994 and 1997, a recovery seemed to take place as the growth picked up, inflation was normalised, and the stock market was seeing growth. This false recovery made policymakers believe that the war was over, but it was actually not.

THE BANKING CRISIS

The true picture of Japan's crisis became clearer in 1997, when a systematic banking crisis erupted. The bubble burst left banks with huge bad loans and failed real estate projects. The losses kept increasing with the years of weak growth, the companies remained heavily indebted, and their share prices fell sharply. All of this led to the complete erosion of bank capital and the collapse of major financial institutions, including Yamaichi Securities and Hokkaido Takushoku Bank. Just when Japan thought things couldn't get any worse, they did, as the economy was simultaneously facing "The Triple Threat".

- **The Policy Mistake:** In order to bring down government debt and ensure fiscal deficits, the

government passed a budget that aimed for a substantial down payment on medium-term consolidation. Now, this budget raised the consumption tax rate by 2%, which led to an overall rise in the tax burden of the residents. This removed approximately ¥7 trillion from the economy.

- Asian Financial Crisis:** The Asian financial crisis is a crisis that was majorly seen over East and Southeast Asia and was caused because of the collapse of the currency exchange rate. For years, large volumes of short-term foreign capital, often called “hot money”, had poured into these economies in search of quick returns, creating asset bubble. When confidence broke, this money rushed out just as quickly, causing currencies to crash and financial systems to destabilise. It worsened the external economic environment of Japan. This led to the damage of the balance

sheets of Japanese banks that used to lend to these Asian nations.

- The Domestic Banking Crisis:** This banking crisis shattered the traditional “Convoy System” in which the strong banks protected the weaker ones. The interbank market systems froze, and the banks refused to lend to one another, creating a severe credit crunch in the economy.

Simultaneously, there was a major shift in Japan's demographics over these decades. The fertility rates fell sharply, while the life expectancy increased. A rapid move was seen from a young and growing population to an ageing and shrinking one. This meant a reduction in the working-age population and slowing of the labour supply in Japan. This ageing structure became a major phenomenon that was seen during the last decades, as it led to weakening of long-term economic growth.

YEAR	1950	1960	1970	1980	1990	2000	2010
TOTAL FERTILITY RATE	3.65%	2.00%	2.13%	1.75%	1.54%	1.36%	1.46%
LIFE EXPECTANCY (MEN)	59.57%	65.32%	69.31%	73.35%	75.92%	77.72%	79.74%
LIFE EXPECTANCY (WOMEN)	62.97%	70.19%	74.66%	78.76%	81.90%	84.60%	86.39%
MEDIAN AGE	22.00%	25.00%	28.5%	33.5%	37.00%	41.00%	47.00%

Source: Research Gate

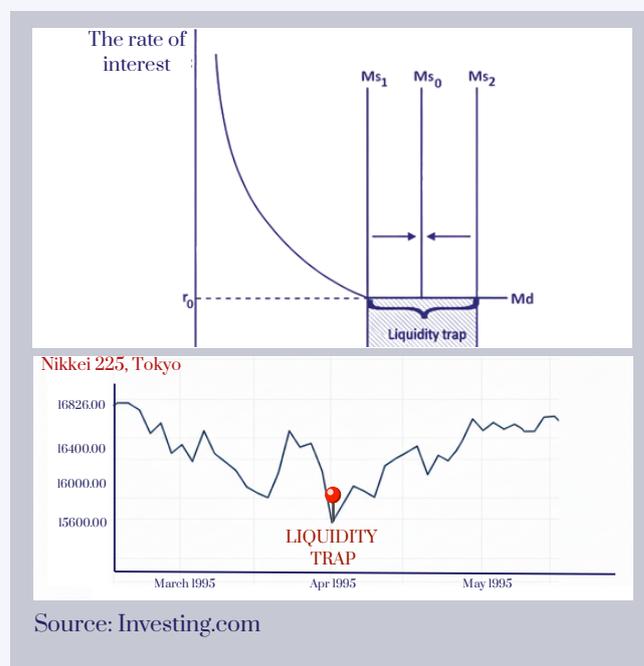
PUSHING ON A STRING

Over these years, the Bank of Japan tried to take many new initiatives. In 1999, it introduced a Zero-Interest Rate Policy (ZIRP). The policy was made to push down the interest rates as low as possible, to around 0.15% and eventually close to zero.

Now, no amount of printing money can push this nominal interest rate below zero. For instance, suppose you could borrow at minus 5%, that means you could borrow \$100 today, keep it as cash, repay \$95 in a year, and keep the difference. That clearly doesn't sound practical. So once the interest rate hits zero, there is nothing that the central bank can do further with the monetary policy to stimulate the economy.

This situation where the monetary policy loses its effectiveness because the interest rates hit the zero lower bound is famously known as “The Liquidity Trap”. And by April 1995, Japan had already fallen into this classic liquidity trap. As a result, the Nikkei Stock Index fell to levels that had not been seen in years. This was because the cheap money could no longer

be translated into higher investments. Instead of flowing the money into productive assets, it used to sit idle with banks and was used to clear bad debts.



Source: Investing.com

At the same time, institutional reforms were also in action. The Resolution and Collection Corporation (RCC) started purchasing the non-performing loans from banks, and the major financial institutions were encouraged to merge. This period is often called "pushing on a string", where monetary and fiscal policies failed to generate enough credit demand in the economy because of the following reasons:

- **Deflationary Expectations:** In a situation of deflation, where prices keep falling, when people expect prices to be lower tomorrow, borrowing today still feels expensive in real terms, even if the interest rates are very close to zero.
- **Hoarding of Cash:** Because of the uncertainty in the economy, households and firms started hoarding cash rather than spending or investing.
- **The Balance Sheet Recession:** Companies focused on paying down their existing debts with the use of the cheap credit rather than using the money to expand their businesses.

Recognising this, the Bank of Japan further adopted an unconventional monetary policy called Quantitative Easing (QE) in March 2001. When the interest rates could not be cut any further, the focus shifted from the interest rates to the quantity of money. Unlike conventional policies, which used to target a specific interest rate, quantitative easing targeted the outstanding balance of banks' current accounts. The main aim of this policy was to ensure ample liquidity in the financial markets. The Bank of Japan flooded the banking system with excess liquidity, raising the target balance of reserves from an initial ¥5 trillion to ¥35 trillion by 2004. Yet there were no signs of growth because injecting money alone cannot fix the problem. Banks continued to lend to the insolvent zombie firms to avoid recognising losses. These companies just survived and did not invest and grow, which affected productivity.

THE ROAD TO REDEMPTION

Eventually, Japan did fix its system collapse by using public money, but it took too long to address the actual problem. Many of the tools that the economy and the government use now were already discussed in Japan in the 1990s, like the asset management companies buying bad loans, guarantees to protect bank liabilities, and the injection of public money. On paper, Japan was doing everything right, but in practice, the system could not be fixed because banks were not forced to clean up their bad loans properly. The system started reshaping only in 2002, under Prime Minister Koizumi and Minister Heizo Takenaka. The government finally encouraged banks to recognise their losses and write off bad debts. Moreover, two major banks were rescued and nationalised, and the zombie banks were forced to close. This loan cleanup helped in reducing stress in the financial system.

Between 2002 and 2007, Japan experienced its

longest growth, averaging about 2%. The stock market was rising and deflation was finally settling down. In later years, Prime Minister Shinzo Abe introduced "Abenomics", a three-arrow strategy consisting of aggressive monetary easing, flexible fiscal stimulus, and structural reform to finally defeat deflation.

This painful history served as a lesson for the global economy. For instance, the United States applied these lessons during the 2008 crisis by taking rapid actions in recapitalising banks, while Chinese policymakers are currently studying Japan's experience to navigate their own asset bubble and surplus savings.

CONCLUSION

History rarely repeats itself, but it has its own way of sending warnings. What Japan was in the 1980s was a confident economic titan that had outrun the limits of financial gravity. Today, as China's rapid growth hits a wall, the world is asking the same question: Is this a temporary slowdown or the start of a "lost decade"?

The Japanese stock market was defined by speculative growth in the 1980s. Between 1985 and 1990, the stock prices doubled, and the Nikkei stock index had climbed to nearly 40,000 points. On the other hand, China's market in 2025 is reacting to a "sharper-than-expected" economic slowdown rather than a boom. There is a 1.7% drop in fixed asset investments, and the index slipped 0.7% in mid-November 2025.

NIKKEI 225 INDEX



Source: Investing.com

SHANGHAI INDEX



Source: Investing.com

Today, as the current situation prevails in China, many wonder if China is the next Japan. However, there is one big difference that lies in the response. Japan's lost decade was born because the policymakers waited years to admit the bad loans of their banks. In contrast, China is choosing a path different from that of Japan. Despite a sharp drop in property values, Beijing has resisted the urge to flood the market with stimulus. They are choosing to restructure the economy now by tackling bad debt rather than flooding the economy with easy money.

China is working hard to change the direction of the story. But under the shadow of Japan's history, the world is watching closely to see whether this slowdown is merely cyclical or the first chapter of a new lost decade.

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