

The 30 Years of Japan's Economic Recession

-- Lessons for China

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ABSTRACT

Japan's "Lost Thirty Years" of economic decline represents not merely an economic cycle adjustment, but a profound crisis stemming from policy missteps, structural transformation failures, and demographic-social shifts. China currently faces multiple challenges including a real estate downturn, soaring debt levels, and population aging - scenarios strikingly similar to Japan's 1980s-1990s period. By analyzing the root causes of Japan's economic collapse - such as policy errors, asset bubble bursts, population aging, and industrial hollowing out - this study explores their implications for China's ongoing economic transition. The analysis aims to help China avoid similar risks and achieve sustainable development.

KEYWORDS

Japanese economy; Lost 30 years; China; Economic transformation; Policy adjustment; Population structure

1. INTRODUCTION

The root causes and characteristics of Japan's economic recession

Since the collapse of its bubble economy in the early 1990s, Japan has endured a prolonged economic recession known as the "Lost Thirty Years". This period exposed multiple challenges including asset bubble bursts, accelerating population aging, and rigid industrial structures, resulting in sluggish growth and persistent deflationary pressures. For China, this case offers profound lessons: it must guard against overheating risks in real estate, drive technological innovation-driven transformation, and proactively address demographic shifts to maintain economic resilience and sustainable development. As a rapidly rising economy, China should learn from Japan's experience by strengthening macroeconomic regulation and structural reforms, avoiding the long-term stagnation trap, thereby consolidating its competitive edge in the global economic landscape [1].

1.1. Policy Chain Errors Trigger Crisis

The monetary-fiscal mismatch: Following the 1985 Plaza Accord, Japan implemented five consecutive interest rate cuts to 2.5% between 1986 and 1987 to counter yen appreciation pressures, while easing financial regulations. This triggered massive capital inflows into stock and real estate markets. The abrupt policy reversal in 1989 saw interest rates rise to 6% consecutively, which directly burst the asset bubble.

1.2. Fiscal Swing and Inefficient Investment

From 1991 to 1998, seven prime ministers were replaced, and the policy repeatedly shifted from stimulus to austerity. In 1997, tax increases further suppressed demand, and a large amount of fiscal funds were invested in inefficient infrastructure (such as bridges on uninhabited islands), wasting policy space.

1.3. The Vicious Circle of Balance Sheet Decline

After the asset bubble burst, businesses and households entered a 15-year "debt minimization" mode: corporate leverage fell from 143.8% in 1994 to 93.2% in 2016, but investment remained sluggish.

1.4. The Consumption Propensity of Residents Plummeted

The growth rate of household consumption dropped from 8.4% in 1990 to 0.2% in 1994. Although the Bank of Japan implemented the zero interest rate policy, the private sector only paid off debts and did not borrow, and the monetary policy was almost ineffective, falling into a "liquidity trap".

1.5. Structural Collapse of Population and Industry

Aging accelerated: The share of the population over 65 rose from 12.9% in 1991 to 29.8% in 2021, and a shrinking labor force is dragging down potential growth.

1.6. Industrial Hollowing Out

The global share of competitive industries such as semiconductors fell from 50 percent in 1980 to 10 percent in 2021, leaving only a few sectors such as automobiles and electronics competitive.

Contemporary China, after four decades of rapid economic growth, now faces unique challenges. Export pressures intensify amid the U.S. 25% tariff and industrial chain relocation, with H1 export growth projected to fluctuate significantly in 2025. Consumer demand weakened as retail sales growth slowed to 4.8% in June 2025, marking a five-month low. This paper analyzes Japan's lessons from policy, industrial, and social perspectives to explore China's path toward risk mitigation and transformation.

2. THE SUCCESSFUL EXPERIENCE OF ECONOMIC DEVELOPMENT IN THE 30 YEARS AFTER WORLD WAR II

2.1. Make Full Use of Fiscal Policy Measures to Stimulate Exports

Japan's Ministry of International Trade and Industry (MITI), established in May 1945, was tasked with promoting the "trade-based nation-building" economic policy. Its export-boosting fiscal measures included: (1) Export Deduction System. In the early 1950s, MITI introduced the "Special Tax Arrangement Measures," allowing exporters to deduct a specified percentage of export revenue as costs - effectively creating a tax-free incentive. This system remained in place until 1964, during which Japan reaped over a decade of "gray area" benefits. (2) Overseas Transaction Depreciation. From 1961 to 1970, MITI permitted qualified exporters to increase depreciation rates by 80%, provided their total export revenue exceeded benchmark annual levels and their export ratio surpassed historical averages. (3) Special Deductions for Technology Exports. In 1959, MITI granted 50% tax-exempt cost deductions for transferring industrial property rights or technology ownership. By 1964, this expanded to include consulting and transportation services, with deduction rates rising to 70% for technology-related income, while remaining at 20% and 30% for other categories. Although MITI has scaled back these deductions under international pressure, it retains exemptions for industrial

property rights, copyrights, and technical services. (4) Export Subsidies. Both direct and indirect subsidies remain prevalent. In terms of direct subsidies, Japan's typical practice is the "dual price", which is mainly used to expand or monopolize the protection of a certain product market, or to induce the penetration and expansion of a certain product into the international market by means of subsidies in order to overcome the sluggish sales in the domestic market.[2]

2.2. Experience in Accession to the General Agreement on Tariffs

After formally joining the General Agreement on Tariffs and Trade (GATT) in 1955, Japan maintained trade protectionist measures for five years to restrict imports and safeguard its domestic market. The country's import restrictions and support for nascent industries during this period exhibited two distinctive features: first, a comprehensive protection framework covering all industrial sectors; second, an integrated approach combining import substitution with export expansion. This strategy created a transitional phase where Japanese society psychologically prepared for but ultimately accepted GATT membership. Concurrently, Japan had already imposed foreign investment restrictions prior to joining. In 1959, Western nations urgently urged Japan to abandon import controls and accelerate trade liberalization. The Tokyo Round of GATT negotiations commenced that November, reaching a peak of international pressure. The Japanese government eventually implemented trade liberalization. By then, nearly five years of protective policies had equipped domestic enterprises with resilience against market risks, while the domestic market approached saturation and export potential was poised for growth. In June 1960, Japan unveiled its "Outline of Trade and Foreign Exchange Liberalization Plan," adopting a phased approach combining gradual openness with limited protectionism to allow enterprises time for strategic adjustments. Contrary to expectations, Japan's economy remained stable after GATT accession. From 1956 to 1973, during the global oil crisis, Japan's GNP grew at an average annual rate of 16%, with foreign exchange reserves reaching \$18.4 billion in 1972 - twenty times the 1956 level.

2.3. Laws and Policies To Protect and Support Small and Medium-Sized Enterprises

Small and medium-sized enterprises (SMEs) constitute 96% of Japan's total business population. The country has long relied on legislative support to foster SME growth. Following World War II, the government established two key financial institutions - the National Financial Cooperative and the SME Finance Cooperative - to provide long-term loans for SME development. Subsequent legislation included the Credit Guarantee Association Law and the SME Revitalization Fund Assistance Law. In 1959, the government launched the Five-Year Plan for Machinery Industry Revitalization, aiming to accelerate equipment upgrades in SMEs. Post-war Japan witnessed two waves of entrepreneurship in small and medium-sized enterprises (SMEs): the 1970s and 1980s. These enterprises have now transitioned from their formative phase to maturity. Characterized by compact operations, youthful teams, and significantly higher R&D investment ratios compared to large corporations, they focus on developing cutting-edge technologies to meet diverse consumer demands. Founding teams often consist of former executives from large enterprises or university professors with proven expertise. Government policies emphasize that SMEs must innovate through product development and production methods to drive industrial progress and foreign trade. Their direct market engagement allows real-time feedback, while their agility enables rapid adaptation to emerging technologies. Moreover, SMEs can concentrate resources on specific projects with lower investment and faster returns.

2.4. Cultivating Japanese-style Competition Mode and Its Advantages

The competition model represents another interpretation of the market economy framework. Unlike the so-called fully free market economies in the US and Europe, Japan's competitive model is government-led and administratively oriented - this explains why Anglo-American countries claim

Japan isn't a true market economy. The defining feature of this Eastern economic model lies in its dual focus on addressing economic and social issues simultaneously. Throughout the long-term process of economic development and social progress, this approach has been marked by prolonged struggles and compromises, filled with twists and turns. The so-called "government-enterprise complex" formed between businesses and the government is internationally dubbed the "Japanese Corporation System." Although private enterprises are the main players, they must implement economic plans formulated by the Government Planning Agency. The government, through the Ministry of International Trade and Industry, implements industrial policies with significant influence over macroeconomic regulation in finance, banking, and foreign trade. Analyzing the financial sector reveals both the strengths and limitations of Japan's market economy model. The "financial iron triangle" composed of financial institutions, businesses, and government while reducing operational costs to some extent before recessions and crises, demonstrated strong government intervention and guidance, but also created institutional flaws that bred massive non-performing loans, property rights disputes between government, banks, and enterprises, and corruption.

3. THE FORMATION OF JAPAN'S BUBBLE ECONOMY AND ITS SUBSEQUENT RAPID COLLAPSE

3.1. The Defects of Japan's Economic and Financial System Laid The Deep Institutional Foundation for the Bubble Economy

3.1.1. Government-led economic development model

Postwar Japan developed a government-led market economy model distinct from those of the UK and US. The government replaced market mechanisms with planned policies to manage economic activities, playing a pivotal role in development direction and resource allocation. This system forced enterprises (particularly SMEs) to rely on government resources for growth rather than strengthening themselves through market competition. Meanwhile, the government implemented export-oriented strategies to support export-driven industries like automobiles and home appliances, while protecting less competitive sectors such as agriculture and services. The sustained access to resources for these traditional industries hindered their transition to high-efficiency sectors, ultimately preventing Japan from achieving structural upgrading during the yen's appreciation period and leading to economic stagnation in the 1990s [3].

3.1.2. Stagnation of industrial structure upgrading

The fundamental principle of economic development dictates that as per capita national income increases, labor shifts from primary to secondary industries and eventually tertiary sectors. Japan successfully transitioned post-World War II from a primary industry-dominated economy to one led by secondary industries, shifting its economic structure from light manufacturing to heavy chemical industries, thereby achieving prosperity and securing a leading position in Asia's "flying geese" economic model. However, entering the 1980s, the information industry emerged as a new global growth engine. This sector required high-risk venture capital financing, but Japan's underdeveloped venture capital ecosystem and reliance on indirect financing models led to funding shortages. Despite Japan's pioneering achievements in information technology research—particularly in semiconductor chips - the government's misguided "large-scale computer development" strategy, which ignored market realities, ultimately caused it to lag behind the United States dominated by personal computers. The stagnation of industrial upgrading redirected capital toward real estate and securities markets, causing Japan to miss out on establishing new dominant industries during the global economic boom of the 1990s [7].

3.1.3. Deficiencies in the financial system

After World War II, Japan maintained a "bank invincibility myth." The Ministry of Finance implemented the "Escort Fleet" system to protect banking interests and prevent failures, positioning banks as quasi-state institutions that dominated the financial system and shaped indirect financing. However, excessive government protection bred weak risk awareness among banks. Their reckless lending fueled a bubble economy, sowing the seeds for future non-performing assets.

3.2. The Mistakes of the Macro Policy of the Japanese Monetary Authorities Contributed to the Bubble Economy

3.2.1. The expansionary monetary policy of maintaining low interest rates for a long time leads to excess liquidity

Following the Plaza Accord in 1985, the Japanese yen continued to appreciate. To counter the impact on the export sector, the Japanese government implemented expansionary fiscal and monetary policies. In 1987, authorities cut the benchmark interest rate to 2.5% and expanded investment through tax cuts. However, their overestimation of economic shocks allowed these expansionary measures to persist for an extended period, leading to excessive liquidity. The surplus capital flooded into real estate and stock markets, significantly driving up land and stock prices, which laid the groundwork for the subsequent bubble economy.

From the mid-1980s to late 1980s, Japan implemented financial liberalization reforms that weakened the role of the main banking system, reduced large enterprises' reliance on bank financing, and spurred the development of financial derivatives markets while intensifying competition in the banking sector. However, the lagging progress of regulatory reforms and an immature regulatory framework resulted in weak risk management capabilities within banking institutions. Against the backdrop of economic prosperity and intensified competition, small and medium-sized enterprises (SMEs) became the primary targets of credit expansion. After obtaining loans, these enterprises heavily invested in real estate and stock markets, significantly inflating asset prices and subsequently fueling the growth of economic bubbles.

3.2.3. Overly aggressive economic policies create prolonged and widespread economic depression after bursting bubbles

The dramatic surge in land and real estate prices ultimately prompted the Bank of Japan to initiate a series of contractionary monetary policies in May 1989. The central bank raised the official discount rate five consecutive times, rapidly increasing it from 2.5% to 6% in the short term and maintaining this high level over the long term. This move triggered sharp declines in real estate and stock market prices, leading to the bursting of an economic bubble, significant depreciation of household assets, and sluggish consumer demand. Concurrently, corporate financial conditions deteriorated, causing rapid expansion of non-performing assets in the banking system. Against this backdrop, the banking sector shifted from "excessive expansion" to "credit tightening," resulting in insufficient social investment scale and further exacerbating the overall economic downturn.

According to the above analysis, the core cause of the formation of Japan's economic bubble and the subsequent decade-long recession lies in the dual role of inherent defects in the economic system and improper policies of the monetary authorities.

4. A COMPARISON BETWEEN CHINA'S HIGH-SPEED ECONOMIC GROWTH AND JAPAN'S "LOST THREE DECADES"

As time goes by, Japan's "lost three decades" has faded from people's view, but the macroeconomic situation of China in the early 20th century can not help but remind people of Japan's experience.

Looking back at the development of Japan's economy, it is not difficult to find that China and Japan have a lot in common in many aspects.

4.1. External Environment Comparison

In the 1980s, Western industrialized nations implemented the Plaza Accord to devalue the US dollar and address their massive trade deficits. However, as Japan's GDP had already risen to second place globally and it held substantial US Treasury bonds (then the largest creditor to the US), historical analysis suggests the Plaza Accord aimed to lower Japan's interest rates through dollar depreciation and yen appreciation. This monetary easing indirectly expanded credit availability by increasing money supply. China faced a similar predicament. When its GDP surpassed Japan's in the early 20th century, it became the world's second-largest economy. Similarly, its foreign exchange reserves were predominantly US Treasury bonds. By September 2008, China's holdings of US Treasury bonds reached \$585 billion, overtaking Japan to become the largest creditor to the US [5].

4.2. Domestic Economy And Real Estate

During the early stages of Japan's economic crisis, as growth slowed and corporate investment in equipment waned, many businesses channeled capital into real estate. Concurrently, banks flooded the market with mortgage loans to fuel property speculation, creating a vicious cycle that fueled the bubble economy. In contrast, Professor Lang Xianping observes that China's economic climate has deteriorated significantly in recent years due to rising interest rates and currency appreciation. Manufacturing sectors struggle to thrive amid constrained profitability, prompting entrepreneurs to shift investments to stocks or real estate—a phenomenon dubbed the "Haier Phenomenon". This pattern reveals how business leaders in both countries have redirected funds toward stock markets and property sectors when domestic industrial investments falter, thereby inflating bubbles in both markets.

4.3. Stock Market

The yen's appreciation severely impacted Japan's exports, leading to shrinking industrial profits. Similar to the real estate market scenario, massive private capital flowed into the capital market, causing a sharp rise in Japan's stock market and triggering a bubble economy. Between 1985 and 1989, the ratio of total stock market value to Gross Domestic Product (GDP) skyrocketed from 60% to 150%. After the economic crisis erupted, the stock market continued its downward trend. By 2002, the Nikkei Index had fallen below 9,500 points—not only far below pre-boom levels in 1985 but also marking an 18-year low.

Looking back at China's rapid economic growth two decades ago, the development of its stock market saw the combined market capitalization of the Shanghai and Shenzhen stock exchanges surge from 3 trillion yuan on July 28, 2005, to surpass 20 trillion yuan by August 3, 2007—a remarkable 6.6-fold increase within just two years. By late 2007, the market capitalization of tradable shares in these exchanges accounted for 50% of GDP, while the total market value represented over 120% of GDP. During the market's peak in 2008, the Shanghai Stock Exchange's price-to-book ratio (PBR) exceeded 7 times, significantly higher than Japan's 5 times level in 1989 [6].

However, the economic landscape of China and Japan differed significantly before their "lost three decades," with the most notable divergence occurring in banking regulation. The flawed financial regulatory framework served as a systemic catalyst for bubble economy formation. Japan's economic crisis originated from banks and securities firms' unbridled investment activities that fueled asset bubbles, while financial institutions' reckless stock and real estate speculation stemmed from inadequate regulatory safeguards. In contrast, China's banking sector is predominantly state-owned,

with only a few financial enterprises holding stakes in banks. This pattern persists across other financial institutions, reflecting the regulatory framework governing China's financial industry.

To sum up, there are significant differences between China's current stock market and Japan's stock market before the signing of the Plaza Accord in terms of economic background, policy environment, market performance and international status. The possibility of China repeating Japan's mistakes is low.

5. CHINA'S LESSONS AND RESPONSE TO JAPAN'S RECESSION

5.1. Clarify the Boundary of Government Functions and Prevent The Risk of Asset Bubbles

The Japanese government's ill-advised decisions and overly abrupt or delayed policy adjustments during its economic bubble response have been key factors behind its prolonged economic stagnation. Therefore, when facing similar economic challenges, China must exercise prudent decision-making. The government should clearly define its functional boundaries which avoiding excessive market intervention while not allowing laissez-faire policies. While ensuring the effective operation of market mechanisms, targeted measures should be implemented to guide healthy market development. Simultaneously, it is crucial to prioritize and rigorously guard against asset bubble risks, learning from Japan's historical lessons [4].

5.2. Strengthen Financial Risk Awareness And Improve The Financial Regulatory System

China's financial system still has room for improvement. To enhance the resilience of its economic framework against global crises, it is imperative to implement adaptive adjustments in line with evolving circumstances. This requires close monitoring of international financial market mechanisms and real-time developments, coupled with precise tracking of capital flows from speculative funds and virtual capital. Only through accurate information analysis and forward-looking assessments can we effectively safeguard the security and stability of China's financial system.

5.3. Resolve the Contradiction of Overcapacity And Promote The Optimization And Upgrading of Industrial Structure

China should learn from Japan's experience and lessons, deepen structural reforms, accelerate industrial transformation and upgrading, focus on enhancing productivity levels, while vigorously strengthening basic research to develop technologies with independent intellectual property rights. Meanwhile, in the process of incentivizing corporate innovation and boosting international competitiveness, the government must avoid excessive market intervention for short-term economic gains. Instead, it should fully leverage the market's natural mechanism of survival of the fittest and maintain a long-term strategic vision for development.

5.4. Strengthening Ecological And Environmental Protection

China faces severe environmental challenges, making ecological protection a central focus of social development. The nation must intensify environmental governance by advancing coordinated efforts in legislation, public oversight, and technological innovation, ensuring sustainable economic growth while effectively addressing environmental issues. Livelihood improvement remains a critical component of social progress. To achieve common prosperity, we should implement mechanisms like wealth-sharing among the affluent and collaborative support systems, along with dedicated funding allocation. Simultaneously, we must rigorously reform bureaucratic practices and promote integrity

in governance. Furthermore, cultivating positive social norms and upholding traditional ethical values are essential for sustainable development.

5.5. Understand the International Environment And Steadily Enhance Its International Status

While nations can seek mutual support and win-win cooperation, a country's long-term development must ultimately be rooted in independence and self-reliance. As China's national strength has significantly increased and its international standing continues to rise, the "China threat theory" has resurfaced from time to time. China has consistently pursued an independent path of peaceful development while actively assisting impoverished nations in overcoming challenges during its own growth process. A thorough analysis of Japan's "lost three decades" reveals economic dilemmas and policy lessons that offer valuable lessons for China to address its current challenges.

6. SUMMARY

This study examines Japan's three-decade-long economic stagnation, analyzing the root causes and impacts of structural issues including policy misalignments (such as monetary-fiscal policy mismatch and balance sheet contraction), accelerating population aging, and industrial hollowing-out. These findings hold significant implications for China, given that both nations currently face striking similarities in their economic trajectories - both grappling with real estate downturns, soaring debt levels, and demographic shifts. By dissecting Japan's experience, policymakers can develop strategies to prevent prolonged economic stagnation, thereby enhancing China's resilience and dynamism in global competition. The research challenges center on accurately identifying and quantifying how multiple factors interacted during Japan's recession, particularly the time lag effects of policy adjustments and external economic shocks. Moreover, the substantial differences between China and Japan in economic systems, developmental stages, and socio-cultural contexts make translating Japan's lessons into China's context a complex task. Compounding these difficulties, China now faces an increasingly intricate global economic landscape marked by trade frictions between the U.S. and China and ongoing restructuring of global supply chains. This paper draws on research literature regarding Japan's "Lost Thirty Years" economic period, covering theories such as the "balance sheet recession" following asset bubbles (e.g., Gu Chaoming's study), the long-term inhibitory effects of population aging on economic growth (as documented in UN Population reports), and analyses of weakening industrial competitiveness. These studies form the theoretical foundation for this work. Building upon Chinese scholars' research on domestic economic transformation, the paper emphasizes the importance of policy regulation, population structure optimization, and industrial upgrading. Integrating these findings, it proposes targeted recommendations from policy, industrial, and social dimensions to address China's current and future economic challenges. Through comparative analysis, the paper reveals China's present situation and challenges, including but not limited to:

- (1) Intensifying export pressure: China is facing the dual pressures of 25% tariffs imposed by the United States and the shift of global industrial chains, resulting in significant fluctuations in export growth in the first half of 2025. This indicates that China's export-oriented growth model is facing severe challenges and it is urgent to explore new economic growth engines.
- (2) Weak Consumer Demand: In June 2025, China's total retail sales of consumer goods growth slowed to 4.8%, the lowest in five months. As a key driver of economic growth, the sluggish consumption reflects deep-seated problems in domestic demand, which urgently need to be reversed through policy stimulus and structural reforms.

(3) Policy and Transformation Pathway Implications

Beware of the risk of overheating in real estate: The lessons from the bursting of Japan's asset bubble warn China that it should avoid over-reliance on real estate to drive economic growth and prevent systemic risks caused by abrupt policy changes.

(4) Promoting Scientific and Technological Innovation and Industrial Transformation: Japan's experience of sluggish industrial upgrading shows that China should accelerate the process of scientific and technological innovation, enhance the international competitiveness of high-end manufacturing and service industries, so as to effectively respond to the challenges brought by the restructuring of global industrial chains.

(5) Responding to demographic transition at an Early Stage: Drawing lessons from Japan's experience in dealing with population aging, China needs to make forward-looking arrangements for the old-age security system, optimize the population structure, delay the shrinking trend of the labor force, and ensure sustainable economic development.

In conclusion, Japan's experience demonstrates that frequent policy adjustments erode market confidence and lead to prolonged economic stagnation. China should strengthen the consistency and coherence of its macroeconomic policies to avoid similar mistakes. Confronting dual challenges of population aging and industrial hollowing out, China urgently needs to advance deep structural reforms to enhance economic resilience and risk resistance capabilities. Amidst the backlash against globalization, China must balance domestic and international demands by expanding domestic consumption, optimizing industrial structures, and boosting technological capabilities to consolidate competitive advantages and achieve high-quality development.

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