JAPANIZATION

WHAT THE WORLD CAN LEARN FROM JAPAN'S LOST DECADES

WILLIAM PESEK
Bloomberg News

Japanization

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William Pesek

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For Eriko. Of course.

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Preface

Few words strike greater fear in the hearts of economists and politicians than *Japanization*. That specter of chronic malaise, deflation, crushing debt, and political paralysis drove central bankers from Ben Bernanke in the United States to Mario Draghi in Europe to flood markets with liquidity as never before in an all-out effort to avert their own lost decades.

Decades ago, the fear was of Japanese dominance. Ezra Vogel's 1979 bestseller, *Japan as Number One*, was emblematic of passions across the Pacific. The Harvard University social sciences professor sketched out a scenario of a tiny island nation with no natural resources dominating the economic world that seemed as plausible as frightening to the American and Europe business elites.

Subsequent years would see entire generations of editors rushing Japanese-are-coming scare pieces into print. *Time* magazine's March 30, 1981, Japan cover, "The World's Toughest Competitor," was illustrative of the hysteria, as was the timing. Amid oil shocks, stagflation, fiscal crises, and the Iran hostage crisis, Japan's meteoric rise was an existential blow to an America whose main business was doing business better than anyone.

Over the next decade, Japan was just as exciting and feared in world economic terms as China is today. Its companies and banks dominated top-10 lists, while once-proud U.S. automakers were eating Japan's exhaust. If you wanted to see some of your favorite Van Gogh, Picasso, or Warhol paintings, you had to visit Tokyo or Osaka. As jewels like Rockefeller Center, Universal Studios, Pebble Beach golf course, and myriad skyscrapers fell into Japanese hands, commentators screamed about the commercial equivalent of Pearl Harbor. Japan-bashing was sweeping Capitol Hill, too. In 1990, Congresswoman Helen Bentley said the United States "is rapidly becoming a colony of Japan."

By 1992, when Michael Crichton's jingoistic novel, *Rising Sun*, about economic imperialism, hit bookshelves, it was already over. By the time the film version of *Rising Sun*, starring Sean Connery and Wesley Snipes, began in theaters in 1993, the Nikkei was plunging and Japan's fabled banks were in need of government bailouts. The Nikkei 225 stock average—which peaked at 38,957—was in freefall and taking Japan's once-limitless confidence down with it.

Since then, Japan has ricocheted from one hapless government to the next (it's had 16 prime ministers since 1990 to America's four presidents), rolled out trillions of dollars of stimulus packages, cut interest rates to zero and below, and done battle with currency markets to weaken the yen countless times, and still deflation has deepened and growth has remained negligible. This noxious mix of trifling growth, high debt, falling consumer prices, waning confidence, and political dysfunction has come to be known as *Japanization*.

It should worry China, then, that experts on this dreaded scenario are turning their attention to Beijing. Take Brian Reading, whose quest to understand what the world can learn from Tokyo's mess dates back to his 1992 book, *Japan: The Coming Collapse*. In July 2013, he wrote a 40-page report with Lombard Street Research Ltd. colleague Diana Choyleva, titled "China's Chance to Avoid Japan's Mistakes."

Over in Hong Hong, investor inquiries on the similarities between China and Japan also drove JPMorgan Chase & Co. economist Grace

Ng to revisit the topic. Her warnings that China today and Japan in the 1980s share an uncannily similar build-up in broad measures of credit to almost double the economy's size brought furrows to many a brow in Beijing.

So, just how susceptible is China to Japanization? How vulnerable, for that matter, are the much larger economies of the United States and the European Union? The answer, at least to varying degrees, is quite a bit. The same could be said for India, Indonesia, Thailand, and other developing economies if national leaders aren't careful.

In February 2009, none other than U.S. President Barack Obama cited Japan's "lost decade" as something his presidency would seek to avoid. In July 2010, James Bullard, president of the Federal Reserve Bank of St. Louis, warned that America could be "enmeshed in a Japanese-style deflationary outcome within the next several years."

When economist Lawrence Summers warned of a "secular stagnation," an economic rout that has more or less become permanent, on November 8, 2013, he was indeed hinting at such an outcome. As the world emerges from the wreckage of Wall Street's 2008 crash and Europe's own crisis deepens, few lessons are more timely or critical than those offered by Japan, a once-vibrant model for developing economies that joined the world's richest nations, lost its way, and has been struggling to relocate it ever since. Its deflation, tepid growth, waning consumer spending, and monumental debt buildup were met with timidity at the government's highest levels, compounding Japan's pain. Conventional tools like fiscal spending and lower borrowing costs did little to revitalize growth and have lost potency.

Why? Tokyo's biggest sin, aside from being slow to act, was hiding myriad structural problems with macroeconomic largess. Beginning in the early 1990s, Japan avoided a wholesale cleansing of the excesses from the 1980s by engaging in endless rounds of Keynesian-style fiscal inducements and ultraloose central bank policy. Instead of breaking ties between the government, banks, and companies, deregulating industries, and letting any of the forces of creative destruction championed by economist Joseph Schumpeter play out, officials maintained the status quo. Rather than encourage entire industries to modernize or rekindle the entrepreneurial spirit needed to raise the nation's game, the government doubled down on the export-led models of the past.

In place of innovative changes to the tax, education, and social-welfare systems, the government poured untold trillions of dollars into public works projects to avoid changes to the micro-economy, leaving Japan with the world's biggest public debt and a credit rating on par with Bermuda, the Czech Republic, Estonia—and China.

In this book I explore what the world can learn from a Japanese economic funk that began more than 20 years ago and has never really ended. That means exploring where Japan went wrong, how it sank under the weight of hubris and political atrophy, and missed opportunity after opportunity to scrap an insular model based on overinvestment, export-led growth, and excessive debt.

This argument will seem decidedly at odds with what we read in the international media in 2013. The story has been one of Japanese revival, of reformist Prime Minister Shinzo Abe taking on the political and corporate establishments, of a newly confident nation reclaiming the mantle of innovative powerhouse and diplomatic authority, of an economic power that is, to use Abe's own description, "back." I will counter this conventional wisdom and detail how *Abenomics* is largely the same old mix of fiscal and monetary excess that left Japan with a public debt it may never be able to pay off, zero interest rates indefinitely, and little to show for it—jazzed up as something new and different. Abenomics is a brilliant marketing campaign in search of a product.

This book will explore the forces stunting Japan's evolution into a more vibrant, creative, and competitive economic species and what the world can learn from each of them. They include: how Japan papers over economic cracks with monetary and fiscal policy; when the bond market becomes a monster; how institutionalized sexism kills growth; how the rampant cronyism the created the Fukushima nuclear crisis holds Japan back; how isolation, known as the *Galapagos effect*, stunts Japan's evolution; how amateurish diplomacy undermines Japan's global soft power; and whether Abenomics can save the world, as no less an authority than Nobel laureate Paul Krugman argues.

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Thanks to my parents for their unwavering love and teaching me to be always and everywhere curious. To my sisters and brothers for being my loyal companions in this adventure called life. To Ochiais near and far for their encouragement and support. And to the following people for their advice, inspiration, and assistance: Shamim Adam, Jake Adelstein, Marco Babic, Terrence Barrett, Kler Batino, Stuart Biggs, Kevin Carroll, Chrisanne Chin, Kyung Bok Cho, John Connor, Michael Forsythe, Brian Fowler, Phil Gibb, James Greiff, Nisid Hajari, Patrick Harrington, Nick Hayward, Peter Himmelman, Barry Horowitz, Momoe Ikeda, Netty Ismail, Aki Ito, Tony Jordan, Adrian Kennedy, Simon Kennedy, Jeff Kingston, Walter Krumholz, Miho Kurosaki, Peter Langan, Yoolim Lee, Roger Lewis, Adam Majendie, Kanoko Matsuyama, Jim McDonald, Damian Milverton, Joe Mysak, Elio Orsara, Tomoko Sato, David Shipley, Rocky Swift, Chian-Wei Teo, Tomoko Tsuchiya, Peter Vercoe, Matthew Winkler, and, of course, Nick Wallwork and the terrific folks at Wiley for taking on this project. Finally, a shout-out to my old friend, the late Daniel Pearl: It was the last time I saw you, 13 years ago, in that smoky bar in Mumbai, when you encouraged me to write a book about Japan. Well, sir, here you go.

Chapter 1

How Japan Papers Over Economic Cracks with Monetary and Fiscal Policy

On November 24, 1997, Lawrence Summers was having an unusually busy Monday morning on a trip to Vancouver, and things were about to get steadily worse. The Asian financial crisis was ricocheting around the globe, and at that very moment claiming its biggest victim yet. South Korea, then the world's eleventh-largest economy, was days away from receiving a $57 billion international bailout. But on that day, the deputy U.S. Treasury secretary had a far bigger problem on his hands, not in Seoul but in Tokyo: the collapse of 100-year-old Yamaichi Securities Co., an event that sent the Dow Jones Industrial

Average down 113 points nearly one month to the day after Asia-crisis worries drove the index down 554 points in a single day, the largest drop ever.

I was among a handful of journalists traveling with Summers to British Columbia for a two-day Asia-Pacific Economic Cooperation summit of 18 world leaders. It started out innocuously enough for the star economist. On the schedule for the twenty-fourth were a bunch of bilateral meetings with finance peers from around the Pacific Rim and the occasional debriefing rendezvous with his boss, President Bill Clinton. At a dinner with his traveling press the night before, Summers seemed to relish a few days away from the madness of Washington and the mounting number of demands ending up on his desk as he prepared to replace Robert Rubin as Treasury secretary two years later. Summers gazed out onto Vancouver Harbor, breathed easily, and enjoyed the calm before the proverbial storm.

Yamaichi's breathtaking implosion the next day represented the largest business failure in Japanese postwar history, and it raised the specter of the then-second-biggest economy joining Indonesia, Malaysia, South Korea, and Thailand in turmoil. For Summers, November 24 was a marathon of frantic face-to-face meetings with Japanese officials, including then–Prime Minister Ryutaro Hashimoto, and International Monetary Fund staffers. By day's end, the most optimistic assessment Summers could offer was that Japan probably wouldn't require a bailout from the International Monetary Fund (IMF). This was a good thing, considering an economy Japan's size might not be too big to fail, but too big to save.

The next day, Hashimoto sought to buttress the point by making a pledge that seemed insignificant at the time. He said Japan is considering a variety of measures to support its shaky financial system, including using public money to bail out the nation's debt-strapped banks. "Japanese citizens, parliament, and the ruling Liberal Democratic Party are all conducting serious debate on this matter, and I'm watching it with real interest," Hashimoto said in Vancouver on November 25. "I'm looking at all possible options and considering further policy steps."

The "options" and "steps" to follow would play a big role in why Japan's first lost decade, the 1990s, would give way to a second and perhaps even a third. Pinpointing the exact moment when modern-day Japan became Japan is fraught with risk and subjectivity. But the downfall of Japan's oldest securities house in 1997 offers a variety of fascinating bookends. Between 1997 and 1998, for example, a year of historic upheaval and big layoffs, Japan's suicide rate jumped 35 percent and has remained around 30,000 per year ever since.

■ ■ ■

Yamaichi was founded in 1897, at the height of the Meiji Restoration, a period of enormous political, economic, and social change that marked Japan's emergence as a modern power. In the years following U.S. Commodore Matthew Perry's arrival in Tokyo Harbor in 1853 and the end of the Tokugawa Shogunate in 1868, Japan sought to leave its feudal past behind and build a market economy. As the nineteenth century wore on, the seeds of Japan's industrialization and economic rise were planted. It was during this era that family business conglomerates, or *zaibatsu*, bearing still-familiar names like Sumitomo, Mitsui, Mitsubishi, and Yasuda, began to dominate. These fabled giants would later make their way into Japanese pop culture, as well as Tom Clancy novels and Western video games like *Grand Theft Auto*. These early corporate formations eventually gave way to Japan's better-known *keiretsu* system of large, state-protected conglomerates that dominated the economy in the twentieth century. Elements of the *keiretsu's* corporate ways persist even today. The most obvious is the practice of strong parts of an organization carrying weaker ones. Another is the custom of cross-shareholdings, whereby companies friendly with each other loan shares of their companies to avoid hostile takeovers.

As the 1800s were drawing to a close, Yamaichi opened its doors and persevered, decade after decade. It survived World War II and helped provide financing for the nation's impressive rise from the rubble and its ambitions for global domination. From the economic launching point that was the 1964 Tokyo Olympics to the heady bubble days of the 1980s, Japan's star rose and rose and its companies couldn't lose. That was until an impossible thing happened as 1989 gave way to the 1990s—at least from the vantage point of top executives in Tokyo. The real estate prices Japanese conventional wisdom said could never fall did just that. The stock market that even many skeptics felt would never stop rising did as well. The proverbial music was stopping and Yamaichi President Shohei Nozawa was left without a chair.

Few Japanese can forget Nozawa's tearful news conference following Yamaichi's 1997 bankruptcy filing where, between sobs, he begged for mercy from the nation. As corporate theater goes, it was unbeatable. Television footage of the bawling Nozawa made the rounds again in February 2010, when Toyota Motor Corp. President Akio Toyoda wept openly at a Washington meeting with car dealers amid a series of safety lapses. Yet Toyoda was no match for Nozawa in the hanky department.

That November week started with one of the masters of Japan's financial universe apologizing and Hashimoto saying he was "ashamed" the Finance Ministry didn't spot the 265 billion yen ($2.6 billion) in hidden losses that brought the brokerage house down. And it seemed like an epochal turning point for Japanese bureaucrats. It's often said, quite correctly, that prime ministers don't run Japan, the bureaucracy does. These largely nameless, faceless policy makers had long decided which companies would live and die—which would get financing to grow and spread their tentacles abroad and which would stay modestly sized backwaters. Yet Yamaichi was a tantalizing example of markets deciding, Lehman Brothers–style. It was skeptical traders who ferreted out Yamaichi's concealed losses and creative accounting. A week later, those same market sleuths were already on to a new target: Yasuda Trust & Banking Co., one of Japan's biggest banks. Moody's Investors Service had said it might knock its debt rating down to junk status. As Yasuda's stock plunged, depositors lined up to withdraw their money, a scene all but unthinkable in wealthy, cosmopolitan, and finance-savvy Japan. Fear was in the Tokyo air. Yamaichi marked the first time Japan allowed a bank to fail in the five decades since World War II, and no one knew who would be next. Who else, a nation of 127 million wondered, might be hiding devastating losses on their balance sheets?

The same week Yamaichi failed, Daiwa Securities, Japan's second-largest brokerage, held an emergency press conference to deny that it, too, was harboring massive losses. That November week is significant because it's arguably the point when global markets began to understand the true depths of Japan's bad-loan crisis and the breadth of the culture of concealment that enabled the problems to fester for many years and at the highest levels of government. It also, with the benefit of hindsight, could have been a major turning point for Japan's approach to dealing with its bad-loan crisis.

That Tokyo let Yamaichi, the oldest of the big four securities houses, fail was seen as heralding a wave of Schumpeter-esque reform. (Joseph Schumpeter was the Austrian economist who championed "creative destruction" and free markets to make nations more competitive.) Financial systems, after all, need to be seen as punishing their weakest links, especially if they lack the transparency global banking norms demand. Yet it would be five years before Japan began getting serious about forcing debt-laden banks to write off the 52.4 trillion yen ($500 billion) of bad loans the government admitted to the industry harboring. For example, in 2002, Standard & Poor's put the number at three times that. That came under then–Prime Minister Junichiro Koizumi (2001–2006), whose economy minister, Heizo Takenaka, clamped down on the banks.

In October 1998, Japan saw its next traumatic banking experience when Long-Term Credit Bank of Japan Ltd. (LTCB) crashed, this time under Hashimoto's successor, Keizo Obuchi (1998–2000). Rather than allow one of the three main banks Japan used to fund its economic miracle to fail, Prime Minister Obuchi's government took control as it launched what at the time was the world's biggest banking industry rescue. The government moved to take over insolvent banks and recapitalize weak ones with a 60-trillion-yen fund. The bailouts continued under Obuchi's successor, Yoshiro Mori (2000–2001), until Koizumi's government said "enough."

Yet the five-plus years between Yamaichi's crash and eventual Koizimi-era reckoning is a period Japan will never get back. It was a window of opportunity to rein in financial excesses, restructure the banking industry, and keep Hong Kong and Singapore from encroaching on Tokyo's place as Asia's premier financial center. How did Japan manage to delay painful and destabilizing change? By employing the so-called *Bubble Fix*, a term popularized by former Morgan Stanley economist Stephen Roach, whereby central bankers and government officials soothe markets with monetary and fiscal stimulants in the short run in ways that create financial imbalances in the long run, essentially curing bubbles with new ones.

It was during the turmoil of Yamaichi failure and LTCB's nationalization that the Bank of Japan first cut interest rates to zero. That honor will always be Masaru Hayami's. His unsteady run as Bank of Japan (BOJ) governor between March 1998 and March 2003 set the stage for the monetary policy regimes later adopted, to varying degrees, by Ben Bernanke at the Fed, Mario Draghi at the European Central Bank, and current BOJ leader Haruhiko Kuroda. The problem with this monetary largess is that it reduces the need for structural change and artificially pumps up asset prices. By creating the illusion of vibrancy in stocks and real estate, and in turn, entire economies, all this free money does more harm than good.

Marc Faber, Hong Kong–based publisher of the *Gloom, Boom, & Doom* report, likens the last 15 years in markets to a relapsing alcoholic, and central banks to irresponsible bartenders. To dole out more booze, as monetary officials have been doing, is the wrong medicine. The problem, particularly in Japan's case, is the lack of an exit strategy. Even when the world's third-largest economy is churning out growth of, say, 3 percent, it's more artificial than organic. Free money sapped the urgency from Japan Inc. at the very worst moment, just as it needed to keep up with a cast of growth stars in Asia, China included. All the liquidity the BOJ has been pumping into the economy since the 1990s was meant to support so-called zombie companies and industries that employ millions. In reality, it led to a zombification of the broader economy, complicating Prime Minister Abe's revival efforts. Japan is still reluctant to abandon the strategies that propelled it into the orbit of Group of Seven nations.

One problem was that even when Japan tweaked its regulatory system, its underlying core remained very much intact. In the 1980s, for example, Japan's "convoy system," whereby stronger banks protected weaker ones, survived, as did the moral hazard policy of not letting banks, large or small, fail. In the first half of the 1990s, even as banks began approaching failure, bankers still felt certain Tokyo wouldn't let a major one fail. While Yamaichi's collapse a few years later altered that view somewhat, Japan spent much of the decade of the 2000s bailing out financial institutions. It can be argued that Japan's entire economy operates in a convoy-system capacity. Because Japan lacks an expansive national safety net, banks inadvertently became one. The government would bail out banks so that they could keep even the dodgiest of companies afloat—and unemployment low.

This arrangement deadened the urgency for banks to write down the bad loans of the past, but so did regulatory structure. In an October 2001 paper, Bank for International Settlements economist Hiroshi Nakaso explored the two main structural problems behind Japan's foot-dragging both on recognizing the depth of its nonperforming-loan crisis and addressing it: insufficient provisioning for debts that go bad and totally inadequate transparency.

"Public disclosure on NPLs was virtually non-existent before 1992," Nakaso wrote.

> The initial disclosure requirement introduced that year was based on tax law standards and covered a limited range of loans to legally bankrupt borrowers and loans past due 180 days or more. Moreover, borrowers' creditworthiness was not necessarily reflected. For example, if a borrower close to bankruptcy had two loans of which one was performing and the other was past due more than 180 days, the disclosure standard required only the latter to be included in the disclosed figures. Consequently, a substantial portion of NPLs remained outside the scope of public disclosure.

Also in 1992, Lombard economist Brian Reading published his prescient *Japan: The Coming Collapse*, tracing the nation's economic miracle, one that formed the core of a development model pursued from South Korea to China to Thailand. The former *Economist* editor has described Japan as "communism with beauty spots, not capitalism with warts." Hyperbole aside, Reading's point is that the mechanics of Japan Inc. have long been rigged in labyrinthine ways to thwart the forces of capitalism.

The core of this system is often referred to as Japan's "iron triangle" of politicians, bureaucrats, and big business, each occupying a corner. Each facilitates the others in achieving their goals and aspirations—rising status for politicians, power for bureaucrats, and riches for corporate chieftains.

"Each side involved exchanges of favors for money," Reading said.

> Under the single-vote multimember electoral constituencies, factional party politicians needed money to buy votes and

> career advancement. They delegated executive power, and to a large extent policy formulation, to bureaucrats. The bureaucrats used their power to do big business favors and were rewarded with sinecures on retirement. In return for preferential treatment, big business supplied politicians with money. Corruption was endemic.

In Reading's view, one could also call this a "plywood triangle," with layers of polygons stuck together. "Each involved an incestuous relationship between individual industries or services, the ministerial or divisional bureaucrats that regulated them, and the politicians who specialized on representing its interests," Reading said.

> Industrialists, bureaucrats and politicians bonded with their triangular partners, colluding to protect their own patch against all others including divisions with ministries, notably in the Ministry of Finance. Each triangle was an independent fiefdom. There was no overall authority to impose change from above. Cabinets rubber-stamped compromise agreements. There is no room here to explain how the system evolved. Suffice it to say there was no central planning. Power was dispersed between segregated boxes.

This arrangement worked wonders for decades, with gross domestic product (GDP) growth averaging nearly 9 percent from the early 1950s into the early 1970s. But then Japan ran into what Reading calls its "three-strikes-and-you're-out" problem. It first began to emerge in the mid-1960s when the nation's obsession with a high savings rate sowed the seeds of deflation. Strike two was the breakdown of the Bretton Woods exchange-rate system, which made it harder to maintain an undervalued currency. The international oil crisis of the early 1970s was strike three, dealing a sizable blow to the nation's capital-intensive industrialization.

Japan's remedy was its first crack at the Bubble Fix. In the 1960s and 1970s, structural changes were needed to reinvigorate growth. But that would mean upsetting the carefully calibrated ways of Japan Inc. It also would have required considerable political will. Instead, three temporary fixes were agreed upon: engineering a current-account surplus, large budget deficits, and extremely easy credit to boost asset markets.

The rationale, Reading said, was that

> excess savings could be lent to foreigners to buy Japan's excess products. A foreigners' financial deficit, also a Japanese current account surplus, would then absorb the private sector's financial surplus. This was the solution to strike one in the late 1960s. But strike two, Bretton Woods collapse, ruled this out as a permanent one. Foreigners are only willing and able to run deficits and debts for a certain period. When they cease to do so, the exchange rate appreciates. Strike three, the oil price explosions, temporarily eliminated current account surpluses and absorbed excess savings by adversely affecting Japan's terms of trade and thereby reducing real income.

U.S. policies during President Ronald Reagan's days from 1981 to 1989, primarily loose fiscal and tight monetary policies, gave Japan a break as the dollar surged. But then the dollar plunged and the yen skyrocketed, thanks to the so-called Plaza Accord in 1985 that Japan agreed to and later regretted. When economists call it one of the greatest policy mistakes Japan ever made, that's saying a lot. Japan, after all, amassed the world's largest public debt, cut interest rates to zero, and scuttled myriad recoveries with bad policies. Some observers think all may pale in comparison to Japan's agreement to let the yen strengthen from 260 yen per dollar to around 125 yen per dollar.

"The currency realignment was too sharp and too large," said Stephen Jen, cofounder of SLJ Macro Partners LLP in London. "Such a sharp appreciation in the currency led to an easy monetary stance that nurtured the financial bubbles (equities and properties), mainly because the BOJ observed that the consumer price index was low, and therefore [it was] safe to run easy monetary policies." He added that "in conjunction with a naïve and short-sighted BOJ, it helped create such large bubbles that helped put Japan out of contention for a generation."

That left Japan turning to massive budget deficits and ultralow interest rates. It's sobering that amid all the talk in 2013 about the Fed finding an exit strategy from quantitative easing, Japan has yet to find its own. Never mind the monetary exploits of the last few years; Japan still needs to find an exit from the 1990s. It hasn't learned how to live