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The Fatal Flaw in Criticism of the Takaichi's Japan Growth Strategy: The Lack of a "Hysteresis Effect" Perspective

Musha Research Co., Ltd.
President
Ryoji Musha
musha@musha.co.jp
http://www.musha.co.jp

Tel ＋81-3- 3740 2143
2-16-7-3912, Konan,
Minato-ku, Tokyo
108-0075, Japan

The Absurdity of the "Growth Strategy Shock" Theory

The draft of the Takaichi Cabinet's "Economic Growth Strategy" was announced on June 30, but it took three weeks before it was approved by the Cabinet yesterday. In the meantime, major media outlets, most notably the Nikkei—have unleashed a barrage of criticism. Their reaction has been nothing short of hysterical, portraying the "Economic Growth Strategy" as though it were triggering market turmoil by weakening the yen and driving up interest rates—the so-called "Growth Strategy Shock."

The Nikkei's criticism is particularly astonishing. On July 18, Setsuo Otsuka, an editorial writer who has long criticized Abenomics and Governor Kuroda's unconventional monetary easing, published a lengthy column entitled "Unconventional Subsidies and the Darkness of Yubari." He compared Ms. Takaichi's growth strategy to the case of Yubari City, which went bankrupt after pursuing excessive investment financed by government subsidies, arguing that her policies were fueling market anxiety through a weaker yen and higher long-term interest rates.

Furthermore, on July 20, Editorial Fellow Harada took an even more direct approach in a lengthy column titled "Withdraw Tax Cuts, Accelerate Interest Rate Hikes." He argued that the Takaichi administration's tax cuts and its policy of restraining interest rate hikes were fueling national instability by weakening the yen and pushing up long-term interest rates and called for a complete reversal of the administration's policies. The argument, however, lacked both fairness and balance.

Many businesspeople and corporate executives who rely on the Nikkei as a basis for their daily decision-making may well conclude that the Takaichi administration's policy mistakes are self-evident. Musha Research firmly believes that such criticism fundamentally misses the point.

The Takaichi administration maintains that Japan's prolonged economic stagnation is not inevitable but rather the result of the negative hysteresis effects created by decades of underinvestment. It also argues that these can be reversed by accumulating the positive hysteresis effects generated through proactive investment. From this perspective, expansionary fiscal and monetary policies that encourage investment are urgently needed.

The nearly 60% rise in the Nikkei Stock Average—from 45,000 to 72,000 (June 23) during the more than eight months since Ms. Takaichi assumed the LDP presidency on October 4 reflects investors' expectations for this policy shift and for an acceleration of Japan's economic growth. Against this backdrop, it is difficult to regard the Nikkei columnists characterization of the recent depreciation of the yen and the rise in long-term interest rates as evidence of national weakness as either fair or convincing.
In what follows, we explain the perspective that the Nikkei columnists has fundamentally overlooked—the concept of hysteresis.

(1) Krugman's New Economic Geography and the Hysteresis Effect

In discussions of Japan's prolonged economic stagnation, issues such as fiscal deficits, demographic decline, labor market reform, and productivity growth have long dominated the debate. Yet one crucial perspective has been almost entirely overlooked: the recognition that the economy exhibits hysteresis.

An economy is not determined by current conditions alone. Past investment, industrial agglomeration, technological accumulation, human capital formation, and policy decisions shape both present performance and future growth potential. Consequently, once an industrial base or growth potential has been lost, it cannot easily be restored through market mechanisms alone. Japan's "Lost Three Decades" is precisely a phenomenon that should be understood through the lens of hysteresis.

Paul Krugman's work provides the theoretical foundation for this perspective. Awarded the Nobel Prize in Economic Sciences in 2008, Krugman demonstrated through his New Trade Theory and New Economic Geography that economic activity is fundamentally path dependent. Industrial location and economic growth are shaped not only by current market conditions but also by historical trajectories and initial conditions. This insight has profound implications for modern industrial policy.

The central proposition of Krugman's New Economic Geography is that the location of industry cannot be explained by comparative advantage alone.Traditional economic theory assumed that firms locate where natural endowments, labor costs, and resource allocation make production most efficient. Krugman showed instead that industrial agglomeration develops through a self-reinforcing process driven by economies of scale, transportation costs, and market size.

As firms concentrate in a particular region, employment expands, attracting more workers and enlarging the consumer market. This, in turn, attracts additional firms, creating a virtuous cycle of industrial agglomeration and economic growth.

This process is hysteresis at work. Once established, an industrial cluster becomes a powerful source of competitiveness. Detroit's automobile industry, Silicon Valley's high-tech and semiconductor industries, Shenzhen's technology cluster, and Taiwan's Hsinchu Science Park are all well-known examples. Conversely, once an industrial cluster has been lost, restoring it is extraordinarily difficult. When firms, skilled workers, research institutions, and supply chains disappear, subsidies alone cannot recreate the original ecosystem. In other words, the economy is governed by the "Irreversible Effects of Time." Time does not heal economic decline; it deepens it. Past stagnation weakens current growth, while today's weak growth further erodes future growth potential. This cumulative process is the essence of hysteresis.

(2) Post-Keynesian Economics and Hysteresis—Demand Determines Supply Capacity

Krugman's analysis extends beyond the field of New Economic Geography and shares important common ground with post-Keynesian economics. A central proposition of post-Keynesian thought is that an economy is determined not solely by supply-side capacity but also by the dynamics of demand, which shape long-term productive capacity.

In neoclassical economics, markets are assumed to converge toward equilibrium over the long run, and demand shortages are regarded as temporary disturbances. Post-Keynesian economics, however, argues that prolonged economic weakness reduces corporate investment, leading to underinvestment in physical capital, technology, and human capital. As a consequence, the economy's productive capacity itself declines. This is the hysteresis effect caused by persistent demand deficiency.

For example, when firms postpone capital investment during an economic downturn, the immediate consequence appears to be merely a decline in investment spending. Over time, however, it results in delayed capital renewal, weaker research and development, and fewer opportunities for human capital formation. As a result, the economy's potential growth rate itself declines. In other words, a prolonged recession is not simply a temporary decline in GDP; it fundamentally alters the structure of the economy.

(3) Japan's Long-Term Stagnation—The Erosion of Industrial Capacity through Hysteresis

Japan's prolonged economic stagnation since the 1990s can be explained through the hysteresis effect.

Following the collapse of the asset-price bubble, Japanese corporations prioritized reducing excessive debt and curtailed investment. At the same time, the government pursued fiscal consolidation by cutting public investment and implementing austerity-oriented policies. As a result, demand remained persistently weak, and companies increasingly emphasized cost-cutting rather than new investment. Furthermore, external pressure from the United States weakened Japanese firms' long-term willingness to invest, and the hysteresis effect gradually eroded Japan's industrial base.

Industries in which Japan once held a competitive advantage—including semiconductors, digital technologies, and energy-related sectors—have lost international competitiveness because of prolonged underinvestment. In addition, employment instability among younger generations has undermined human capital formation. What is important is that these are not merely "economic problems." Rather, it is the cumulative loss of investment, technological accumulation, and opportunities for human capital development that has shaped the structural weakness of today's Japanese economy.

(4) Criticism against the Criticism of " the "Growth Strategy"—The Hysteresis Effects of Fiscal Orthodoxy

The most fundamental weakness in the criticism of the "Growth Strategy is its excessive emphasis on fiscal consolidation and its failure to recognize the hysteresis effects on industrial development. Fiscal sustainability is, of course, important. However, when the economy is stagnating and private-sector investment is already weak, reducing government expenditure only entrenches demand deficiency. As a result, corporate investment declines further, weakening the nation's industrial base. Policies aimed solely at reducing the fiscal deficit may improve the fiscal balance in the short run, but they undermine long-term economic strength.

What is needed is to regard government spending not merely as consumption but as investment that builds future productive capacity. Investment in research and development, human capital formation, energy security, and strategic industries lay the foundation for future tax revenues and long-term growth. As Krugman's theory demonstrates, once industrial clusters and technological capabilities are lost, they do not recover spontaneously. That is why governments must play an active role in changing the trajectory of economic development through long-term industrial policy.

The economy exhibits hysteresis. That is precisely why policy must change the course of economic development. What Japan needs is not a policy that merely manages the failures of the past, but a national strategy that builds the industrial foundations of the future.