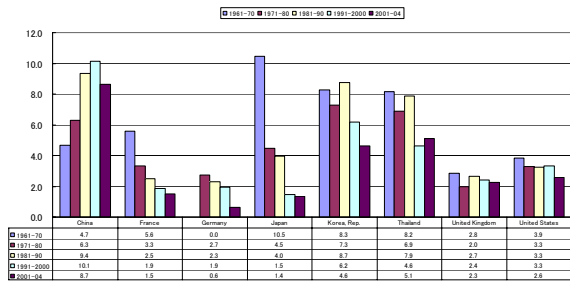


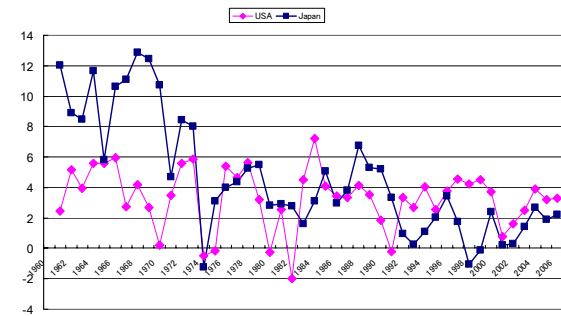
The Bubble Economy and its Burst

Japan in the 1980s and 1990s

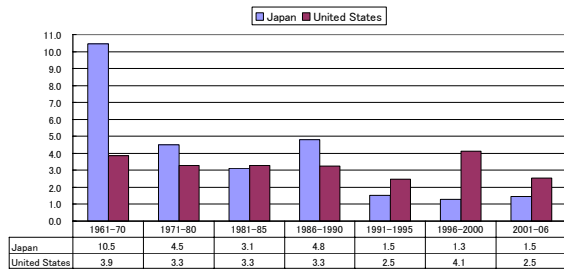
GDP Growth rates



US vs. Japan, GDP growth rates, 1960 - 2006

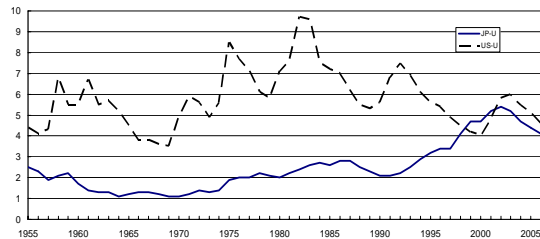


GDP Growth rates Japan vs. United States



Labor conditions

Unemployment rate: 1955 - 2006
U.S. vs Japan



Structure of Japan's stable growth

- Strong growth in private consumption
- Well-educated labor force
 - Almost no conflict b/w management and labor and between blue and white collar workers
- Stable political environment
 - 55-system
 - Emergence of technocrats
- Stable geopolitical environment
- “Dual system”
 - Tradable sector vs. non-tradable sector
 - Manufacturing vs. service sector
- Egalitarian fiscal policy

Price of Japan's stable growth

- Labor force with weak creativity
- Corruption and collusion in the political arena
- "Dual system"
 - Super-competitive sector vs. super-inefficient sector
- Dysfunctional cross-subsidy scheme vs. Egalitarianism

The "Bubble Economy" in the 80s and its Collapse in the 90s

- The current recession ("Heisei recession": 平成不況) started w/ the burst of the bubble in the asset markets in 1990.
- But initially, this is something Japanese people wanted ...
- **The system that fueled the economic boom in the 1980s has become the core of the problems in the 1990s.**

In Sum, ...

- Change in banking sector in Japan
 - ➔ Led to "easy credit" during the 1980s
 - ➔ Investment, especially in asset markets, boomed, so did bank lending
- US "Twin Deficits" fueled credit expansion in Japan
- After the collapse of asset markets, Japan's financial system became dysfunctional b/o non-performing loans

Banking Structure up to the '70s

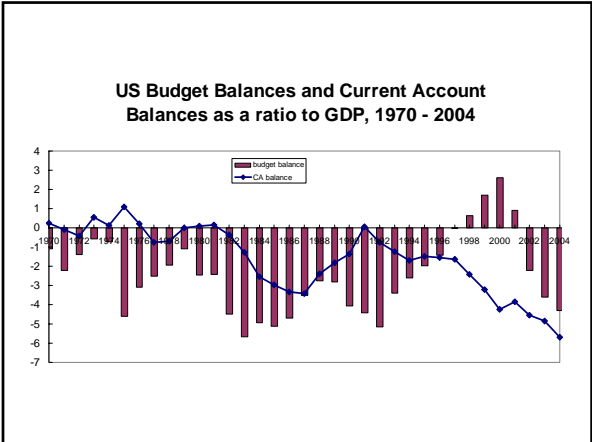
- Up to '70s – Division of Labor in Japanese finance
 - City banks/industrial banks (public banks)
 - Financed large corporations/projects for infra. building
 - Regional banks, credit unions, agri-coops
 - Financed SME, individuals (self-employed)

Banking Structure after the '70s

- Change in the division of labor (late '70s and early '80s)
 - Internationalization of corps. + Financial liberalization
 - Big MNC such as Toyota and Matsushita started financing in overseas markets
 - Big banks lost their traditional customers
 - Banks started demanding deregulation in banking industry to expand their territories
 - Big banks started retailing, squeezing other smaller banks
 - Smaller banks also started demanding financial deregulation ex. *Jusen* (住専)

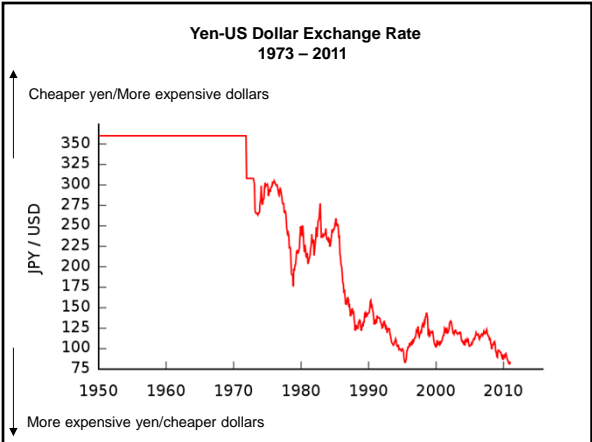
U.S. also demand Japan's financial deregulation

- The “Twin deficits” became severe under the Reagan administration
 - Tight monetary policy in 1981-82
 - High gov't spending
 - Large tax cuts → Reaganomics
 - US dollar appreciated
 - Contributed to trade deficits
 - U.S. trade deficits against Japan were already politicized since 1960s
 - Yen was claimed to be undervalued



U.S. also demand Japan's financial deregulation

- In the early 1980s, US trade policy started becoming protectionist
- And, the US Gov't started demanding Japan to liberalize financial markets
 - The **"Yen-Dollar Committee"** (1983): The reason why US dollars do not depreciate is because Japanese financial markets are closed, making it less attractive to invest.
 - Japanese authorities are maintain an artificially low level of interest rates in Japan
- Japanese banks perceived US gov't as a good ally to demand further financial deregulation/liberalization with



Déjà vu of the pre-Plaza accord period (1981 – 1985)

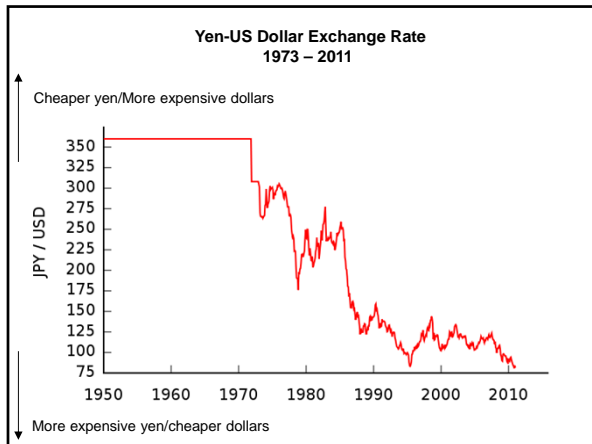
- **Japan** is the *biggest contributor* to U.S. CA deficit
- **Japan**, with *manipulative currency policy*, keeps its *currency undervalued* and keeps *dumping exports* to U.S. markets
- **Japan** *needs to revalue* its currency, and
- *develop and liberalize its financial markets*, so that
- **Japan's** *excessively high saving rate* will go down, and that
- **Japan's** enormous current account surplus will be *recycled within the country (or the region)*, *not flowing into the U.S.*

The savings glut argument is popular in Washington (2000s)

- **China** (or East Asia) is the *biggest contributor* to U.S. CA deficit
- **China**, with *manipulative currency policy*, keeps its *currency undervalued* and keeps *dumping exports* to U.S. markets
- **China** *needs to revalue* its currency, and
- *develop and liberalize its financial markets*, so that
- **China's** *excessively high saving rate* will go down, and that
- **China's** enormous current account surplus will be *recycled within the country (or the region)*, *not flowing into the U.S.*

Japan's financial deregulation/liberalization

- In 1984, GOJ announced it will implement financial dereg./lib. policies.
- Ironically, GOJ's liberalization policy enhanced more Japanese investment to the US and contributed to stronger US dollars
- Consequently, US trade deficits worsened
- 1985:9 – The Plaza Accord
 - G7 countries agreed to “correct” the value of US dollars by intervening the markets
- Yen soared afterwards → hurting J's exports



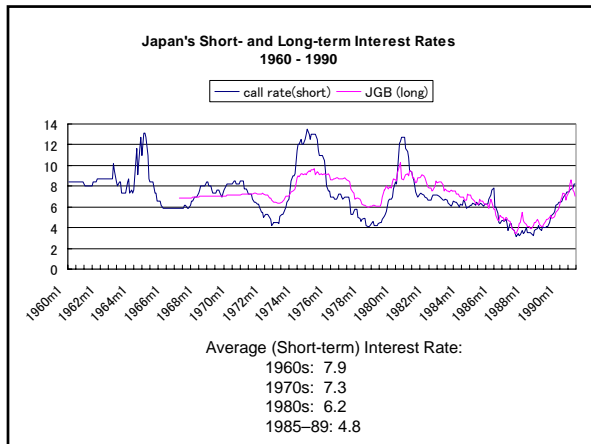
**Financial expansion (?)
in the late 1980s**

- Strong yen hurt the competitiveness of the export sector → High Yen (En-daka) Recession in 1987
- US Black Monday (Oct.19, 1987)
 - DJ fell 22.6%, 41.8% in Australia, 22.5 in Canada, 45.8% in HK, 26.4% in UK
- Japan was intact and quickly lowered the interest rate, which it was already lowering after the Plaza accord.

**Financial expansion (?)
in the late 1980s**

Credit expansion occurred in Japan

- **Circumstantial reasons: Low *i* policy**
 - “High yen recession” (1987)
 - US Black Monday (Oct. 1987)
 - Government debt (early 1980s) + Privatization
- **Structural reason:** Change in Banking structure

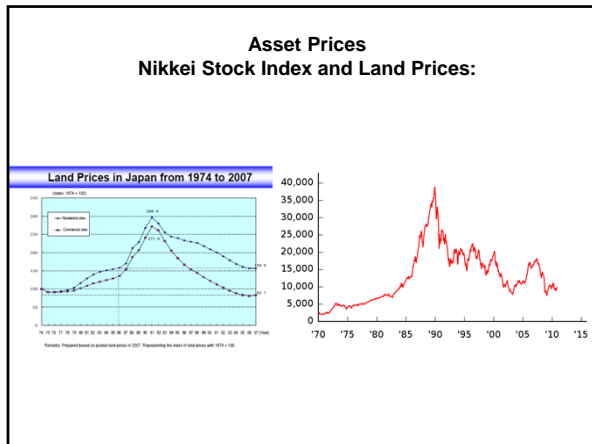


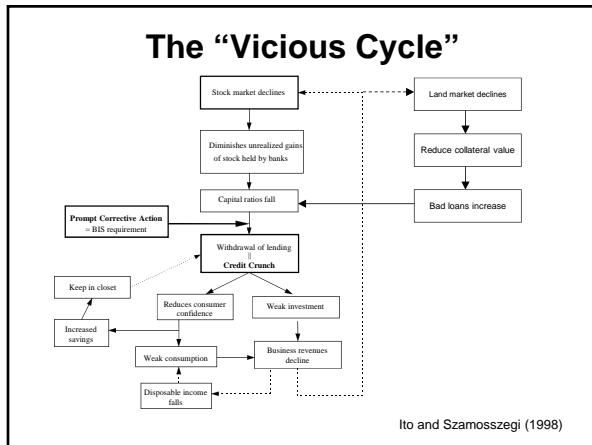
Credit expansion in the late 1980s

- Thinner profits, but larger lending
- This was sustainable as long as the value of land kept rising. → **Land as collateral**
- Rising stock market prices → increasing lending
 - Banks are allowed not only to hold shares of corporations, but also to include the capital gains as part of their capital, *i.e.*, **the higher the stock market level, the more capital, and the more lending.**

The Burst of the Bubble ...

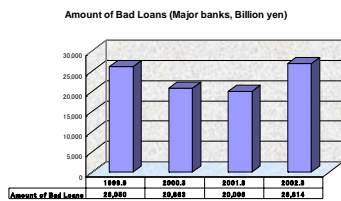
- Asset inflation became a social issue
- BOJ guided higher interest rates in 1989
- The stock market collapsed in 1990.
 - By Oct. '92, the Tokyo stock market lost its value by 50%.
- The land market value started declining in 1992.
- The anti-wealth effect or the vicious cycle started in the early 1990s.





Bad loans are bad!

- Total Amount of Bad Loans:
 - 43.2 Trillion Yen (\$360 Billion), as of March 2002
 - 29% up from previous year
 - Roughly 9% of total lending (It was as high as 15% in 1998)
 - c.f. In US S&L - 7% of GDP



The “Lost Decade”/The “Great Recession” (1991 – present)

1991 – 1995

- Asset deflation
- Reversed wealth effect: “Vicious cycle”

1995 – 1996

- Yen appreciation
- Massive fiscal expansion

1997 – 1999

- Fiscal contraction
- Banking crisis

1999 – present

- Deflation, Liquidity trap
- Social security system crisis

Macroeconomic policies were ineffective

Macroeconomic Policies

- Fiscal policy (Gov’t spending and tax cuts)
- Monetary policy
- (Exchange rate policy)

Macroeconomic policies were ineffective

- **Government spending** (J-gov’t spent about \$1trillion during the 1990s)
 - Well, it did work, maybe. The economy could’ve been worse w/out massive fiscal spending in the early 1990s.
 - But, it was not as effective.
 - Diminishing returns
 - Public works spending in less productive areas ← Pork barrel: highways, roads, dam, ports, etc. “in the middle of nowhere”

Why didn't macro policy work?

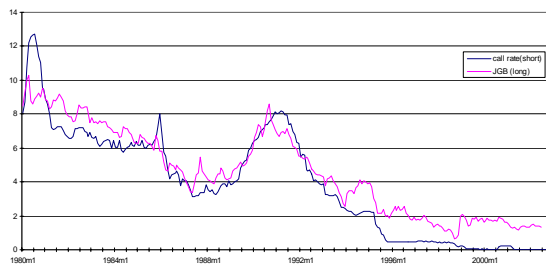
• Tax Cuts

- No one to give tax cuts to:
 - 60% of possible tax payers aren't paying taxes after a series of tax cuts
 - Too high minimum taxable income
 - "Don't favor the rich!!"
- "Ricardian equivalence" (late '90s on) due to mounting government debt

Why didn't macro policy work?

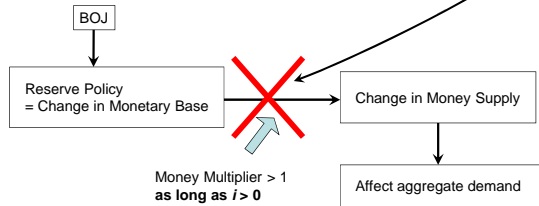
- **Monetary policy** – not effective especially in the late 1990s
 - "Liquidity Trap"
 - Financial crisis in 1997 – 98

Japan's Nominal Interest Rates

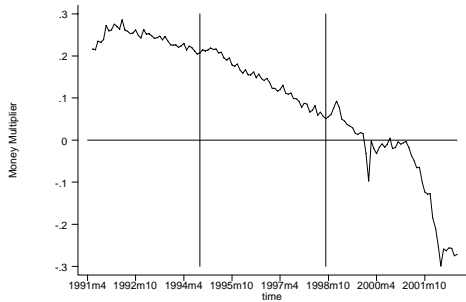


The “Liquidity Trap”

- Monetary policy is ineffective given $i = 0$ (September 1999 – present).



Money Multiplier, 1991:4 – 2002:10



Note: Money multiplier = $\ln(M2) - \ln(MB)$. Both M2 and MB are seasonally adjusted by the X-12 routine.

Political Inertia

- Climate change inside and outside Japan and rigidity in the system
- Lack of objective policy analysis/policy debates
- Legacy of the Cold War
 - Extreme risk averse behavior / Avoidance of social fragmentation
 - Conservatism / status quo
- Legacy of the war economy – “If the markets aren’t working *properly*, why doesn’t the gov’t intervene?” (cf. rise in foreign investors)
