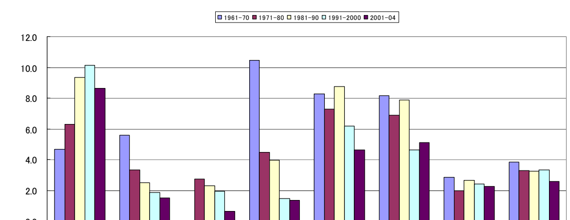
The Bubble Economy and its Burst

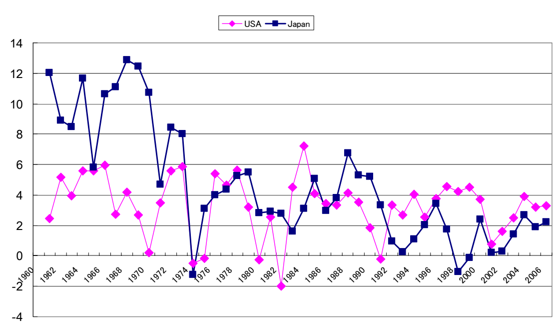
Japan in the 1980s and 1990s

GDP Growth rates

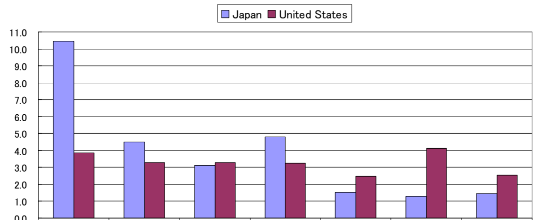


	China	France	Germany	Japan	Korea, Rep.	Thailand	United Kingdom	United States
1961-70	4.7	5.6	0.0	10.5	8.3	8.2	2.8	3.9
1971-80	6.3	3.3	2.7	4.5	7.3	6.9	2.0	3.3
1981-90	9.4	2.5	2.3	4.0	8.7	7.9	2.7	3.3
1991-2000	10.1	1.9	1.9	1.5	6.2	4.6	2.4	3.3
2001-04	8.7	1.5	0.6	1.4	4.6	5.1	2.3	2.6

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



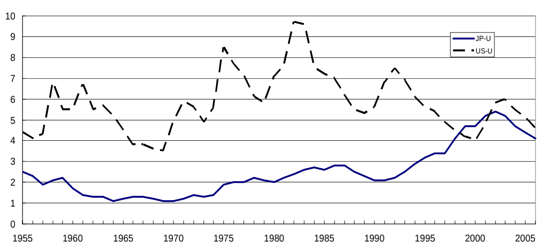
GDP Growth rates
Japan vs. United States



	1961-70	1971-80	1981-85	1986-1990	1991-1995	1996-2000	2001-06
Japan	10.5	4.5	3.1	4.8	1.5	1.3	1.5
United States	3.9	3.3	3.3	3.3	2.5	4.1	2.5

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)

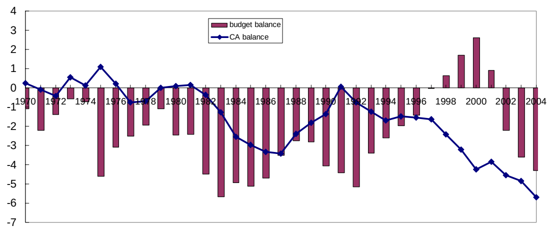
Banking Structure after the '70s

- 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

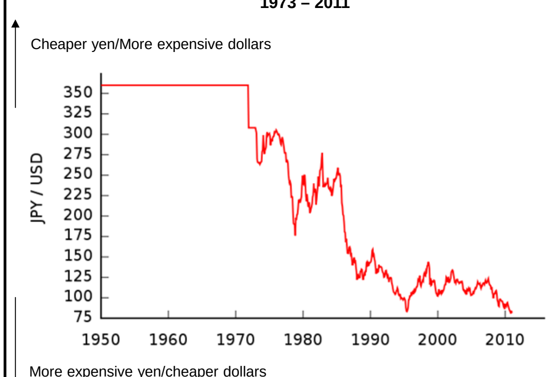
US Budget Balances and Current Account Balances as a ratio to GDP, 1970 - 2004



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

Yen-US Dollar Exchange Rate
1973 – 2011



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
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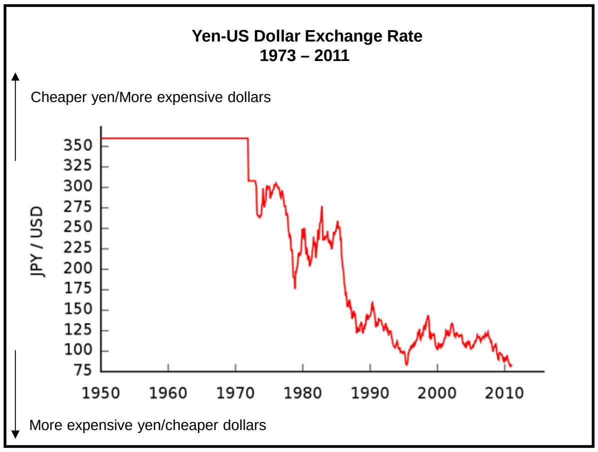
Japan's financial deregulation/liberalization

- 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

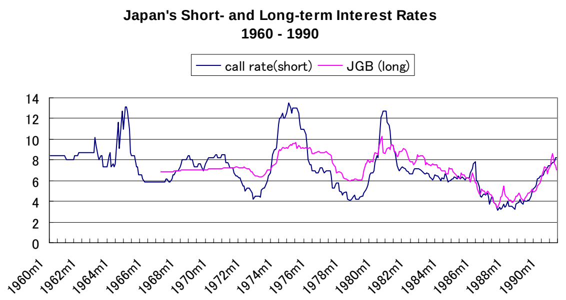
- Strong yen hurt the competitiveness of the export sector ➔ High Yen (En-daka) Recession in 1987
- US Black Monday (Oct.19, 1987)
  - DJ fell 22.6%, 41.8% in Australia, 22.5 in Canada, 45.8% in HK, 26.4% in UK

➔ 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



Average (Short-term) Interest Rate:
1960s: 7.9
1970s: 7.3
1980s: 6.2
1985–89: 4.8

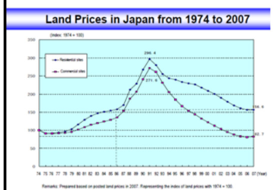
Credit expansion in the late 1980s

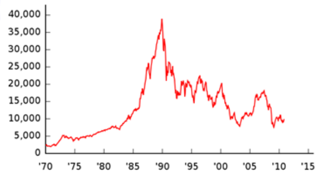
- Thinner profits, but larger lending
- This was sustainable as long as the value of land kept rising. → **Land as collateral**
- Rising stock market prices → increasing lending
  - Banks are allowed not only to hold shares of corporations, but also to include the capital gains as part of their capital,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

The Burst of the Bubble …

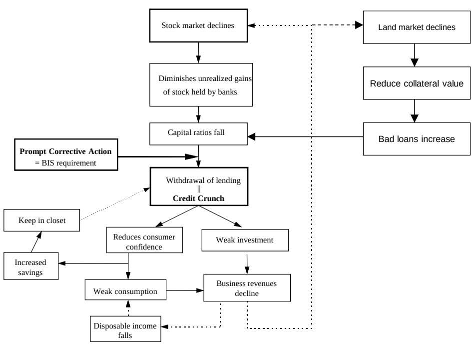
- Asset inflation became a social issue
- BOJ guided higher interest rates in 1989
- The stock market collapsed in 1990.
  - By Oct. '92, the Tokyo stock market lost its value by 50%.
- The land market value started declining in 1992.
- The anti-wealth effect or the vicious cycle started in the early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

Asset Prices
Nikkei Stock Index and Land Prices:





The "Vicious Cycle"

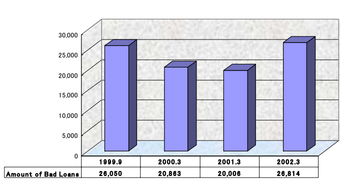


Ito and Szamosszegi (1998)

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**

Amount of Bad Loans (Major banks, Billion yen)



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"

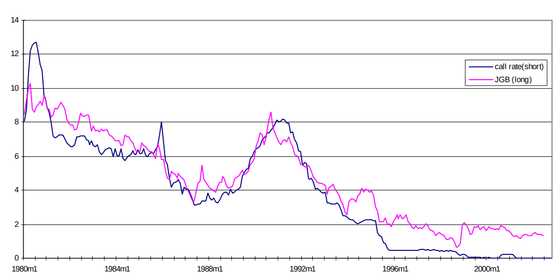
Why didn't macro policy work?

- **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?

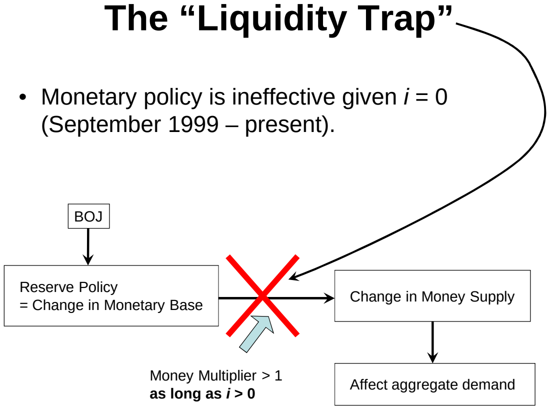
- **Monetary policy** – not effective especially in the late 1990s
  - "Liquidity Trap"
  - Financial crisis in 1997 – 98

Japan's Nominal Interest Rates

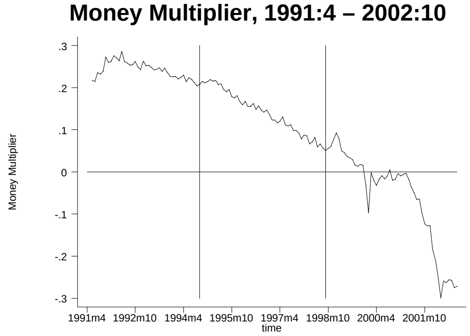


The "Liquidity Trap"

- 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)