In 1990, Japan was on track to become the #1 economy

- Average Real Growth was exceptionally high in postwar period
  - 1950-1970: 8.4% annual per-capita
  - 1970-1990: 3.4% annual per-capita (4.1% unadjusted)
- Large Trade Surpluses, especially with U.S.
  - Offset by high rates of investment in U.S. and Asia.
- Value of Yen rising
  - 360 Yen per Dollar before 1971, 300 in 1973, 130 in 1990 - an average appreciation rate of 4% per year.
- Per-capita GDP higher than U.S.
  - Adjusting for Purchasing Power Parity, 81% of U.S. level (30% of U.S. level in 1870, 20% in 1929 and 1950)

Then the Bubble Burst

- Prices of Stocks fell dramatically:
  - After rising from 12,000 in 1985 to 39,000 in 1989, stocks fell to 16,000 by 1992.
  - Real Estate and other Assets similarly affected.
- Bubbles happen, and bubbles burst, but in Japan the decline never ended.
  - Currently, the Nikkei is around 12,000.
After 1991, Japan also stopped growing

- Between 1990 and 2004, average real per-capita growth averaged around 1.0%.
- Four identifiable recessions.
- After a year or so of hope, another one may be beginning.
What happened to Japan?

Why the world’s second largest economy slowed down

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Sources of Japanese Growth

- High Savings Rate:
  - Minimal consumer credit markets
  - Weak social security system, firm-based retirement
  - Very little foreign direct investment, lending
  - Postal savings system
  - Accumulation of capital, research & development
- Focus on high-quality production
- Export Orientation:
  - Subsidization by MITI
  - Undervalued exchange rate until 1971
- Main Bank System (i.e., Keiretsu):
  - convoy system of mutual support
  - lifetime employment
  - iron triangle of LDP, technocracy, large firms

Events in the International Money Markets

  - Bank of Japan bought Dollars to prevent Yen appreciation, inflating money supply.
  - Then 1973-1975 OPEC Oil Crisis helped accelerate inflation to 25%, BOJ began to tighten up, exports expanded, and Yen started appreciating.
- 1981-1985: In U.S., tight monetary policy in U.S. combined with large federal budget deficits led to high real interest rates and a rising Dollar.
  - Louvre Accord in 1987: Agreement that Dollar had fallen enough. Bank of Japan began buying Dollars and increased rate of money growth, so interest rates fell to historic lows.
Creation of the Bubble Economy

- In spite of financial liberalization in the late 1970s and 1980s, financial system was dominated by mutual support systems between politicians, financial institutions, and regulatory authorities which limited bankruptcy.

- Regulatory and market innovations (e.g., deposit guarantee system) subsidized risk taking, both by financial institutions and their business clients.

- Accommodative monetary policy in the second half of the 1980s, as Bank of Japan focused limiting Yen appreciation, plus high GDP growth rates and low inflation rates, made asset values increase.

- Increased monetary growth led to increased bank lending, which increased the demand for land, real estate, and equities. Feedback effect supported additional lending (land as collateral for loans and “hidden reserves” in determining bank capital.)
Bursting the Bubble

- Low interest rates and high expected earnings growth led to rising asset prices:
  - Housing/income ratio in 1983 equals 6.7 times the ratio in 1950 (7.9 times in Tokyo). From 1985-1989 it tripled again.
  - The Nikkei index more than tripled in three years.
- The Bank of Japan raised the discount rate in May 1989, and continued with tight monetary policy through 1994.
- The decline in asset prices weakened bank balance sheets, reduced investment and consumption spending, and generated a nonperforming loan and borrower problem.
- In hindsight, the Bank of Japan continued too long with tight monetary policy and did not shift aggressively enough to monetary easing after 1993, when its policy changed.

Financial Distress

- Regulatory authorities were unwilling to close insolvent financial institutions, permit bankruptcy in the corporate sector, and instead adopted a policy of denial and avoidance.
  - Accounting gimmicks, “white knight” mergers and other “convoy system” approaches in which the stronger supported the weaker
- Regulators were unwilling to allow bankruptcy to remove inefficient capital from the market (especially in the financial sector), and this “forgiveness and forbearance” continued to support weak borrowers.
  - Those who could not obtain credit from the banking system shifted to government banks in the Fiscal Investment and Loan Program.
  - Postal deposits grew relative to total deposits in response to increased concern about the stability of the banking system, and provided increased funding for government banks.
- Financial distress only increased:
  - insolvent institutions, nonperforming loans
Fiscal Policy

- LDP lost power in 1993, Hosukawa stepped down in 1994, then a rapid turnover in weak coalition governments until Koizumi came to power in 2001.
- Government consumption spending rose after 1994, financed in part by deficit spending. In 2003, the deficit was 25% of government spending, and government debt rose to 200% of GDP.
- Fiscal stimulus packages were enacted that did little: traditional “pork barrel” spending (e.g., construction) and loan guarantees.
- Yen appreciated through 1995, exports fell by a third; Yen then fell, but exports slow to recover.
- Combined with the nonperforming loan problem embedded in the private banking system and the nonperforming loan problem embedded in the FILP, Japan has accumulated an unprecedented amount of debt.

Monetary Policy

The Bank of Japan not only imposed tight monetary policy for too long a period of time in the early 1990s, but it also failed to prevent disinflation from becoming deflation.

When the BOJ finally acted, it focused on decreasing nominal interest rates (e.g., the ZIRP) but failed to recognize that the decline in prices had increased the real rate of interest.

Fisher equation: real interest rate = nominal rate - expected inflation.

Low interest rates therefore did not mean than monetary policy was stimulative.
Why is Deflation a Problem?

Inflation in Japan was already low in the late 1980s, but inflation rates fell further. After 1994, inflation turned negative.

Is deflation a cause or just a symptom?

In Basic Model of Aggregate Supply and Demand, an economy in recession can be returned to full employment by either:

- Stimulating Aggregate Demand through Monetary Policy or Fiscal Policy, or
- Allowing the Price Level to fall so that value of money and other paper wealth rises relative to the cost of products.
Unexpected Effects of Price Deflation

- Fisher’s Debt-Deflation connection:
  - Debt repayment becomes more difficult, firms default on loans.
- Real Interest Rate rises, decreasing Investment.
- Money Demand increases:
  - If bonds and other debt instruments pay really low interest rates then people may prefer to hold more money, which pays zero interest.
- Consumption falls in anticipation:
  - Consumers who expect deflation may wait for prices to fall before buying.
- Money Supply tightens:
  - If banks prefer to hold safer government bonds and cash than to lend, then the Deposit Expansion Multiplier shrinks.
  - Money Supply may not grow even when the Central Bank increases the Monetary Base.

Deflation makes it worse...

Price Deflation as a result of an increase in Aggregate Supply is no big deal.

During a recession, Price Deflation can make things worse by further reducing Aggregate Demand.

Monetary Policy can become much more difficult to implement. Money Demand increases, and it becomes more difficult for the Central Bank to increase Money Supply.

Eliminating deflation requires the Central Bank to convince markets to expect inflation. Temporary or timid efforts to increase money supply will cause money demand to rise, but not prices.
Why So Little, So Late?

- The BOJ wanted to force the Ministry of Finance to reform the banking system, so it delayed intervention.
- Once interest rates fell and the BOJ bought government bonds to increase the monetary base, it did not want interest rates to rise with inflation because that would weaken its balance sheet.
- The BOJ did not understand the severity of the deflation problem, and was concerned that creating inflation would undermine its reputation.
- The BOJ did not want to admit it was wrong.
- After a year of trying to stimulate the economy with rapid money growth, the BOJ is now targeting monetary reserves – another misguided policy.
Many Changes in the Japanese Economy

- Gradual acceptance of the need for closing down insolvent firms and banks.
- Gradual erosion of the Keiretsu system, the lifetime employment system, and other features of the Japanese system.
- Lifting of restrictions on foreign investment and ownership.

Continuing Problems

- Most Japanese do not see this as a crisis; Japan is still a wealthy, high-tech society, albeit with weak growth.
- Most Japanese voters continue to support the LDP, perhaps due to the spending projects in their district. Koizumi comes from a reformist faction in the LDP, but the opposition outside the LDP is disorganized.
- Reform since 1997 is significant but still lagging and insufficient.
- Large exporting firms able to “opt out” by going to international markets, and do not press for more reform.
- Japan has an aging population, with women increasingly opting out of both parenthood and the workforce.
- Deflation continues to be a problem.