



# JOINT ECONOMIC COMMITTEE

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RESEARCH REPORT #110-30  
December 2008



## POLICY LESSONS FROM JAPAN'S LOST DECADE

Japan experienced large asset price bubbles in its stock and commercial real estate markets during the second half of the 1980s. These bubbles peaked in 1989 and 1990, respectively. Subsequently, both Japanese share prices and land values fell, surrendering all of their gains during the bubble years by 1993 and 2000, respectively.

After these bubbles popped, real GDP growth slowed abruptly. However, a series of fiscal and monetary blunders by the Japanese government transformed the inevitable post-bubble recession into a "lost decade" of deflation and stagnation. U.S. policymakers can learn valuable lessons of what to do and not to do by studying these blunders.

**Sowing seeds.** During the second half of the 1980s, Japan enjoyed both rapid economic growth and low inflation (as recorded in price indices for goods and services). The Japanese yen appreciated from ¥260/US\$ in February 1985 to a then all-time high of ¥150/US\$ during the summer of 1986. Fearing a loss of price competitiveness for Japanese manufactured exports in the United States, the Japanese government changed the thrust of its economic policy from non-inflationary real GDP growth in Japan to containing the appreciation of the yen relative to the U.S. dollar.

Despite a booming economy, the Bank of Japan loosened its monetary policy to stem the appreciation of the yen by reducing its policy interest rate in steps from 5.0 percent in January 1986, to 2.5 percent in February 1987. This overly accommodative monetary policy fueled unsustainable price bubbles in the Japanese stock and commercial real estate markets.

To prick these bubbles, the Bank of Japan began to tighten its monetary policy, raising its policy interest rate from 2.5 percent in May 1989 in steps to a peak of 6.0 percent in August 1990. This tightening caused these bubbles to pop:

- The Nikkei 225 index, which was 13,000 at the end of 1985, peaked at 38,916 on the last

trading day of 1989 and then fell by one-half in 1990. By 1993, all of the gains in share prices since 1985 had been eliminated. The Nikkei 225 index declined to a post-bubble low of 11,820 on March 13, 2001.

- The urban land price index rose by 199 percent from 35.1 in September 1985 to a peak of 105.1 in September 1990. The index then gradually declined over the next ten years to 34.6 percent in September 2000, eliminating all of the gains in real estate prices since 1985.

The collapse of these bubbles wrecked Japanese banks and other depository institutions:

- Japanese banks and other depository institutions were allowed to invest directly in stocks. The unrealized capital gains on these shares fell from ¥49.1 trillion (\$355 billion) in 1989 to ¥5 trillion (\$42 billion) in 2001, reducing bank capital.
- Japanese banks and other depository institutions secured almost all of their commercial and industrial loans through commercial real estate mortgages. As commercial real estate values escalated, credit standards deteriorated. Instead of examining whether non-financial firms could service their loans out of their cash flow from operations, Japanese banks and other depository institutions increasingly relied on rapidly escalating collateral values for repayment. Weak credit standards during the bubble years boosted problem loans and credit losses in Japanese banks and other depository institutions during the lost decade.

This weakness in Japanese banks and other depository institutions had especially devastating effects on the non-financial business sector in Japan because Japanese non-financial firms were more dependent on bank loans than their counterparts in the United States and other developed countries during the 1980s:

- Japanese non-financial firms generally had higher debt-to-equity ratios than their U.S. or European counterparts.
- The Japanese corporate debt market was relatively shallow. With less ability to issue commercial paper and corporate bonds, Japanese multinational firms (MNFs) relied more heavily on bank loans to finance investment than U.S. and European MNFs.
- Many Japanese non-financial firms, whose primary operations had nothing to do with real estate development, began speculating on commercial real estate as the bubble inflated. Widespread speculation devastated the balance sheets of these firms after the commercial real estate bubble popped.

**Banking crisis.** Once these bubbles burst, Japanese banks and other depository institutions were saddled with mountains of non-performing loans. At first, the Japanese government played for time through a policy of forbearance. Japanese banks and other depository institutions delayed recognizing their losses on non-performing loans to insolvent non-financial firms. Instead, Japanese banks and other depository institutions continued lending to insolvent non-financial firms to keep them from filing for bankruptcy. This lending expanded the size of the non-performing loan problems at Japanese banks and other depository institutions during the first half of the 1990s.

By the middle 1990s, unrealized stock losses, loan charge-offs, and write-downs depleted the capital of many Japanese banks and other depository institutions. The failure of several *jusen* (specialized housing lenders) in 1995 forced the Japanese government to abandon its policy of forbearance.

Instead of forbearance, the Japanese government encouraged Japanese banks and other depository institutions to (1) “stop throwing good money after bad” and (2) charge-off non-performing loans to insolvent non-financial firms. Cumulative loan charge-offs from 1995 to 2003 were ¥37.2 trillion (\$318 billion). Despite these loan charge-offs, non-performing loans did not peak until 2002 when they reached ¥43.2 trillion (\$330 billion), or 8.4 percent of total loans.

The Japanese government also decided to (1) provide taxpayer funds to aid capital-impaired

banks and other depository institutions, and (2) assist stronger banks to acquire failing banks and other depository institutions. Because of widespread public opposition, however, this policy of government assistance and consolidation proceeded in fits and starts. Over the next decade, the Japanese government provided total assistance of ¥46.8 trillion (\$399 billion) to Japanese banks and other depository institutions through grants, asset purchases, equity injections, and other means. As of March 31, 2007, ¥22.8 trillion (\$195 billion) of this assistance has been recovered.

Although this policy of government assistance and consolidation cost Japanese taxpayers ¥24.0 trillion (\$204 billion), it worked. Japan now has a handful of well capitalized banks and other depository that are capable of providing the credit to Japanese households and firms necessary for sustained economic growth.

**Lost decade.** As the financial condition of Japanese banks and other financial institutions deteriorated, credit for both entrepreneurs and new ventures of existing non-financial firms became scarce. Japanese non-financial firms slashed their research and development expenditures, retarding the diffusion of new technologies. These factors slowed productivity gains and stymied real GDP growth.

In July 1991, the Bank of Japan began to loosen its monetary policy. The Bank of Japan reduced its policy interest rate in steps to 0.5 percent by year-end 1995. As its policy interest rate approached zero, the Bank of Japan engaged in quantitative easing. Nevertheless, the real GDP growth rate stalled, averaging only 0.7 percent from 1992 to 1994, and disinflation morphed into deflation. This accommodative monetary policy failed to spark real GDP growth because:

- Weighed down with non-performing loans, Japanese banks and other depository institutions were unwilling to extend new loans to non-financial firms despite very low funding costs; and
- Japanese non-financial firms wanted to reduce their leverage and repair their balance sheets before borrowing additional funds to expand their operations.

As for fiscal policy, the Japanese government tried to stimulate real GDP growth by increasing

infrastructure spending from 6.5 percent of GDP in 1990 to 8.3 percent of GDP in 1996. Instead of boosting real GDP growth, additional infrastructure spending actually hurt the Japanese economy:

- Since the Japanese government had spent far more on infrastructure as a percent of GDP than the United States or other developed countries, Japan had very few unfunded infrastructure projects that would increase productivity.
- In Japan, the choice of infrastructure projects is highly politicized and prior to 2002 was made without any cost-benefit analysis. Japanese politicians have traditionally competed for Diet seats based on their ability to “bring home the bacon” especially to rural constituencies. As a result, Japanese infrastructure projects are notoriously wasteful (e.g., rural roads with little traffic, bridges to islands with few residents, and expensive seldom-used harbor facilities for small fishing villages).
- Japanese construction firms are very inefficient compared with their counterparts in the United States and other developed countries. Infrastructure spending channeled taxpayer funds to one of Japan’s least efficient sectors.
- Japanese politicians and political parties are heavily dependent on contributions from Japanese construction firms, while Japanese construction firms are heavily dependent on public infrastructure projects. This co-dependency has caused numerous “pay to play” scandals involving large illegal campaign contributions and payoffs from construction firms to policymakers.

The exposure of these scandals and widespread waste in infrastructure spending by the Japanese media forced the government to reverse its policy in 1997. By 2004, infrastructure spending fell to 4.8 percent of GDP.

When infrastructure spending did not spark a recovery, the Japanese government implemented temporary income tax reductions in 1994. These reductions boosted real GDP growth to 2.8 percent in 1996. However, concerns about Japanese government budget deficits caused the government to couple these temporary income tax reductions with a permanent increase in the consumption tax from 3 percent to 5 percent, effective April 1, 1997. After this permanent tax increase was implemented,

real GDP contracted at an annualized rate of 3.3 percent in the second quarter of 1997, and real GDP continued to shrink in both 1998 and 1999.

Moreover, this tax increase did not reduce the Japanese government budget deficit. Instead, it rose from 3.8 percent of GDP in Japanese fiscal year 1997 to 7.2 percent of GDP in Japanese fiscal year 1999.

**Differences.** Before discussing lessons learned, it is important to observe several important differences between the Japanese experience and the current situation confronting U.S. policymakers:

1. The asset price bubbles in the Japanese stock and commercial real estate markets were country-specific. The residential real estate bubble was global, occurring simultaneously in the United States and many other developed countries with floating exchange rates, including Australia, Ireland, Spain, and the United Kingdom.
2. The Japanese policy to pursue an overly accommodative domestic monetary policy to contain the appreciation of the foreign exchange value of the yen caused the stock and commercial real estate price bubbles in Japan during the second half of the 1990s. The causes of the residential real estate bubbles in the United States and other developed countries with floating exchange rates are complex and involve many macroeconomic and microeconomic policy errors by both the U.S. government and foreign governments.<sup>1</sup>
3. In Japan, non-financial firms were overleveraged and had weak balance sheets, while the household sector was in better shape when the stock and commercial real estate bubbles popped. In the United States, households were overleveraged and had weak balance sheets, while the non-financial business sector was in better shape when the residential real estate bubble popped.
4. Japan maintained significant current account surpluses during the bubble years and the lost decade. The United States has run significant current account deficits.

**Lessons for U.S. policymakers.** The bursting of the stock and commercial real estate price bubble in Japan and the subsequent lost decade offers many

lessons for U.S. policymakers during the current global financial crisis and recession:

1. A recession inevitably follows the popping of a large asset price bubble. However, policy decisions made during the recession will affect both (1) its severity, and (2) the trajectory of the economy following the recession.
2. The banking system must become financially healthy before a sustained expansion can occur. U.S. banks and other financial institutions recognized their losses more rapidly than Japanese banks and other financial institutions. Moreover, the U.S. government injected taxpayer funds into U.S. banks and other financial institutions during this financial crisis far more quickly than did the Japanese government during the lost decade.
3. The balance sheet of the economic sector (business or household) that suffered the most damage from the collapse of a large asset price bubble must be repaired before a sustained expansion can occur. In Japan, non-financial firms had to reduce investment and use their profits to reduce their debt and rebuilt their balance sheets during Japan's lost decade before sustained growth resumed. Now, financially stressed U.S. households must reduce consumption and increase their saving rate to reduce their debt and rebuild their balance sheets. Thus, any portion of federal income tax reductions or rebates that households save should not be regarded as a failed stimulus. Normal economic growth cannot resume until this structural adjustment in the U.S. household sector is complete. "Saved" federal tax relief may speed this necessary adjustment.
4. Unlike Japan, international imbalances were a major macroeconomic cause of the residential real estate price bubble in the United States and many other developed countries with floating exchange rates. The correction of these imbalances may require difficult international negotiations to limit the ability of national governments to manipulate exchange rates.
5. While temporary income tax reductions helped Japanese economy in 1995 and 1996, the simultaneously enacted permanent increase in the consumption tax to reduce the Japanese

government budget deficit in 1997 extinguished the benefits of these temporary reductions, sending the Japanese economy back into a recession. The automatic termination of the federal income tax reductions enacted in 2001 and 2003 on December 31, 2010, may diminish the stimulus from any temporary federal tax reductions or rebates during 2009 and 2010 and may further weaken the U.S. economy in 2011.

6. Additional infrastructure spending may not bolster either short-term or long-term economic growth. First, there are lengthy delays between when infrastructure projects are authorized and when actual construction starts. Because of such delays, the desired boost in employment may occur months after a recession is over. Second, the ability of infrastructure projects to increase productivity and real GDP growth are unequal. To boost productivity long-term growth, policymakers must carefully select which projects they fund to screen out "boondoggles." Such a thorough selection process and a rapid funding of infrastructure projects to create jobs during a recession are in conflict. A rush to approve a large number of infrastructure projects may lead to wasteful expenditures that do not increase productivity and boost real GDP growth over time.

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<sup>1</sup> Macroeconomic causes include the interaction between (1) the exchange rate policy of the People's Republic of China (PRC) and the shadow exchange rate policies of other Asian countries to keep the foreign exchange values of their currencies below market-clearing levels after the Asian Financial Crisis of 1997-1998, and (2) implementation by either practice or rule of inflation-targeting by the Federal Reserve and central banks in other developed countries with floating exchange rates. This interaction distorted price signals globally. Over time, these price distortions produced (1) overinvestment and malinvestment in finance and housing sectors in the United States and many other developed countries with floating exchange rates, and (2) overinvestment and malinvestment in the manufacturing sector in the PRC and many other Asian countries. Microeconomic causes include (1) lacunas in the Basel capital standards, (2) a fundamental conflict in the business model of credit rating agencies, (3) fundamental flaws in the "originate to securitize" model of residential mortgage finance, (4) the inherent mission conflict in Fannie Mae and Freddie Mac, and (5) various policies that promoted home ownership among low- to moderate-income households that were not able to shoulder these responsibilities.