Japanese Asset Bubble

Prepared under ECONS Project, IIT Kanpur

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1 Acknowledgement

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Contents

2 Synopsis

This report tries to explain the Japanese asset price bubble, a phenomena which occurred in 1980-90 and saw a very sharp increase in asset prices including land and stock market. After World War, Japan has risen again and become the King of Electronics and the country with one of the highest PPP within three decades, thanks to the factors which includes government policies, domestic savings, low value of Yen, stable politics and American Defence Protection. However, the things changed after the Plaza Accord of 1985, which led the government to follow expansionary monetary policy. The property and stock prices sky-rocketed. This euphoria led to massive speculation which ultimately led to the burst in 1990 and consequently, the lost decade.

3 Introduction

Post World War II Japan was growing at the very fast rate. It became the leading exporter of electronics in the world market. Moreover,the automobile industry was greatly was also making new strides. Sony and Hitachi were expected to buy out Intel and other giants of USA. Then the twist in the tale came with the plaza accord signed in 1985 and the subsequent monetary policies which led to Asset Bubble and its burst which led to sharp fall in asset prices - the Japanese Index Nikkei 225, the property market and led to the creation of zombie banks and companies which finally led to the lost decade. The report presented highlights all these aspects along with various illustrations. All the data is collected from various sources and appropriately highlighted.

4 The Miracle Economy (1950-80)

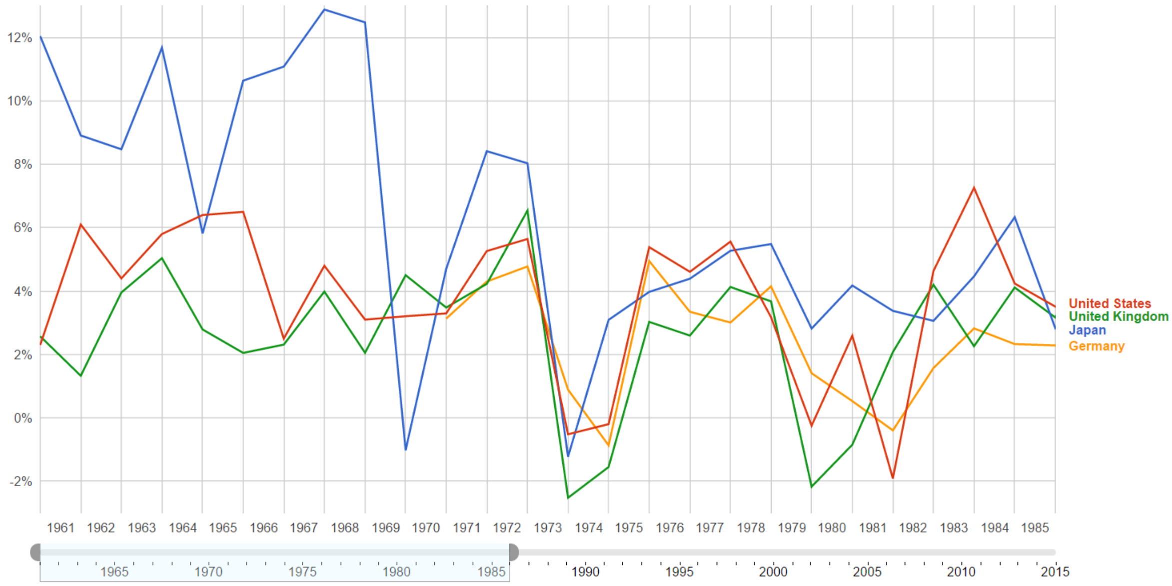
The miracle economy was the term coined for the economic growth period of post World War II, between 1950 and 1980s to the sharp growth shown by Japan first in Automobile Industry and then from 1970s in electronics industry. The creation of Giants like Sony, Hitachi swept the whole market towards them. Hence, Japan got the title of King of Electronics.

Excluding chip making where Intel and others were leaders, nearly every electronic products industry was held by Japanese firms. Besides the quality, the other reason for this was the innovation. Japanese firms covered the inherent disadvantage of deficiency of resources by focussing more on innovation and research. The innovative products like Sony Walkman created the same craze as is today for Apple iPhones or its other products. The relatively small firms before World War II, Mitsubishi and Toyota during this period emerged as the top competitors in automobile market. Newer entrants like Honda also made the same stride. The prime reason was the assembly-line robots which makes the error nearly zero. It was not introduced in US until 1970s and sent shivers in US automobile market. Another benefit was from the Oil Crises during 1973. The demand for oil guzzling V8 engines declined and demand for more efficient cars increased, the ones like of Honda and Nissan.

Tokyo became a major financial center, home of some of the world's major banks, financial firms, insurance companies, and the world's largest stock exchange of its time, the Tokyo Securities and Stock Exchange.

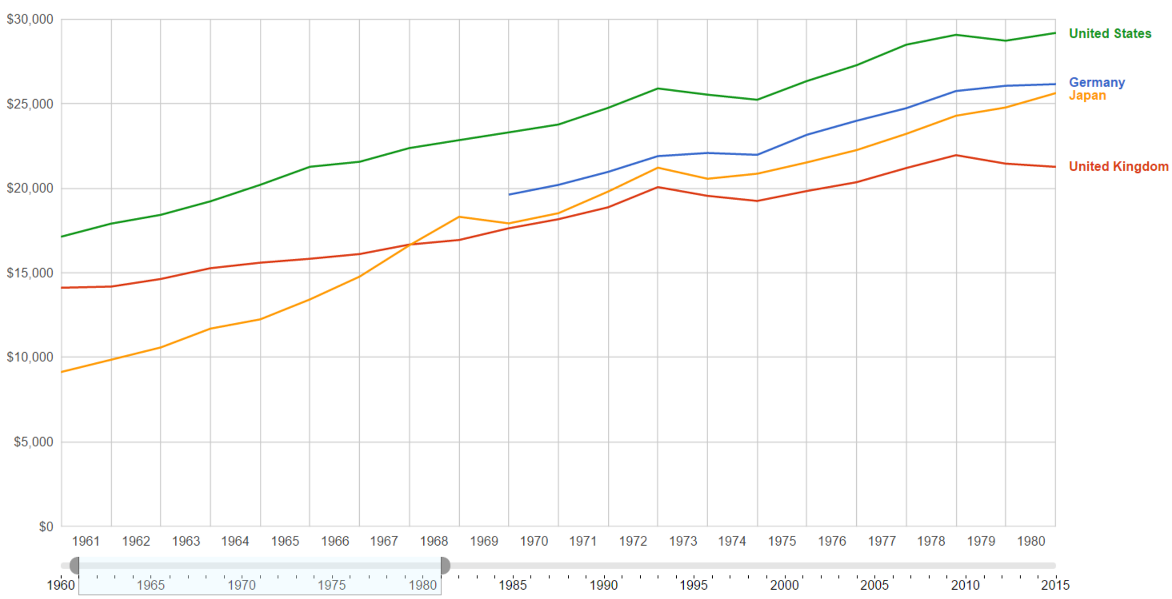
Country's standard of livings rose rapidly with PPP (Purchasing Power Parity) reaching and even exceeding that of the developed countries of best, making it the second largest economy after USA. During this era, the GDP growth rate in Japan this time was 3 times more to that of its western partners. Following is the data :

Fig 1 : GDP growth rate comparisons



Source : Google Public Data

Fig 2 : GDP per capita (constant 2000 US$)



Source : Google Public Data

5 Reasons

5.1 MITI (Ministry of International Trade and Industry)

MITI has served as an architect of industrial policy, an arbiter on industrial problems and disputes, and a regulator. A major objective of the ministry has been to strengthen the country's industrial base. It has not managed Japanese trade and industry along the lines of a centrally planned economy, but it has provided industries with administrative guidance and other direction, both formal and informal, on modernization, technology, investments in new plants and equipment, and domestic and foreign competition.

The close relationship between MITI and Japanese industry has led to foreign trade policy that often complements the ministry's efforts to strengthen domestic manufacturing interests. MITI facilitated the early development of nearly all major industries by providing protection from import competition, technological intelligence, help in licensing foreign technology, access to foreign exchange, and assistance in mergers.

In short, Government gave push to industrial development. MITI handled conflicting policies like Exports v/s Pollution Control and supported Japanese companies totally.

In 2001, its role was taken over by the newly created Ministry of Economy, Trade and Industry (METI).

5.2 American Defence Protection

Under Marshal Plan, Japan was not allowed to keep army. This led to the minimal defence expenditure(for country's administration only). US provided protection to Japan.

5.3 Very Low Yen

Low yen value compared to dollar made the exports very competitive, which supplemented the good quality of innovative Japanese products (Japan overcome the inherent problem of deficiency of natural resources by developing innovative and new technologies and improving the current.) Sony, Honda, Hitachi, Toyota became global brands.

5.3.1 Huge Domestic savings

Japan had a huge amount of domestic savings which led to the easy credit availability. This helped a lot in making investments and to raise the money for economic activities.

Exports increased which led to large trade surplus.

5.4 Iron Triangle

Bureaucrats, Corporate leaders and Politicians worked together. Bureaucrats became industry friendly. Focus was given on 2 sectors :

$$RisingSector -> Automobile$$

$$DecliningSector -> Mining$$

The sole aim was to maximise exports.

5.5 Stable Politics

This time saw a major political change. In 1955, two conservative parties - Japan Democratic Party and Liberal Party merged to form LDP(Liberal Democratic Party) which possessed a huge majority and led to stable politics.

Fig 3

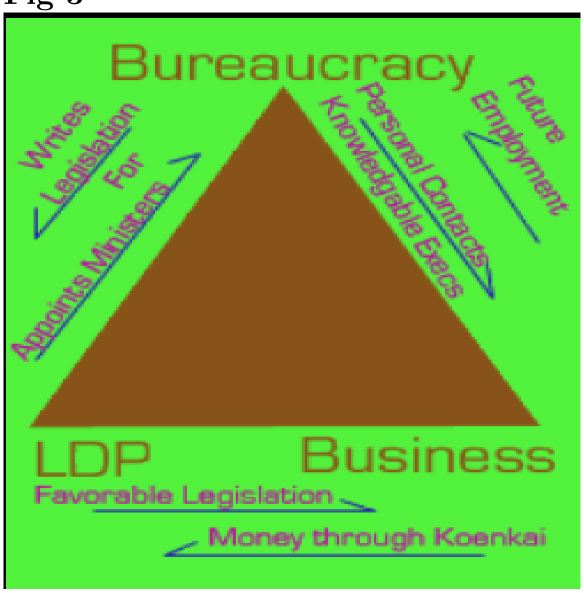


Fig 4

Source : Google Images

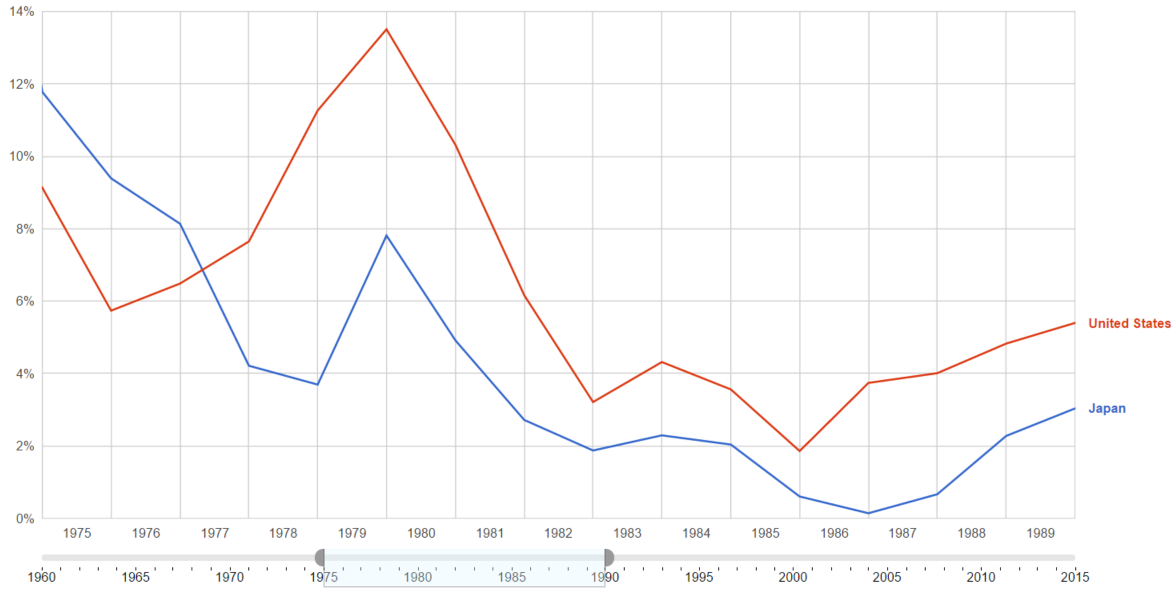
6 Twist In The Tail : Plaza Accord

What is it? In 1985, the G5 countries -West Germany, France, the United States, Japan and the United Kingdom signed an agreement called the Plaza Accord to manipulate exchange rates by depreciating the U.S. dollar relative to the Japanese yen and the German Deutsch mark.The five governments signed the accord on September 22, 1985 at the Plaza Hotel in New York City.

Aim: The Aim was to the reduce current account deficit of USA (which was reaching 3% of the GDP), overcome negative growth rate in Japan and European countries. What gave the Plaza Accord its historic importance was a multitude of firsts. It was the first time central bankers agreed to intervene in the currency markets, the first time the world set target rates, the first time for globalization of economies and the first time each nation agreed to adjust its own economies. Sovereignty was exchanged for globalization.

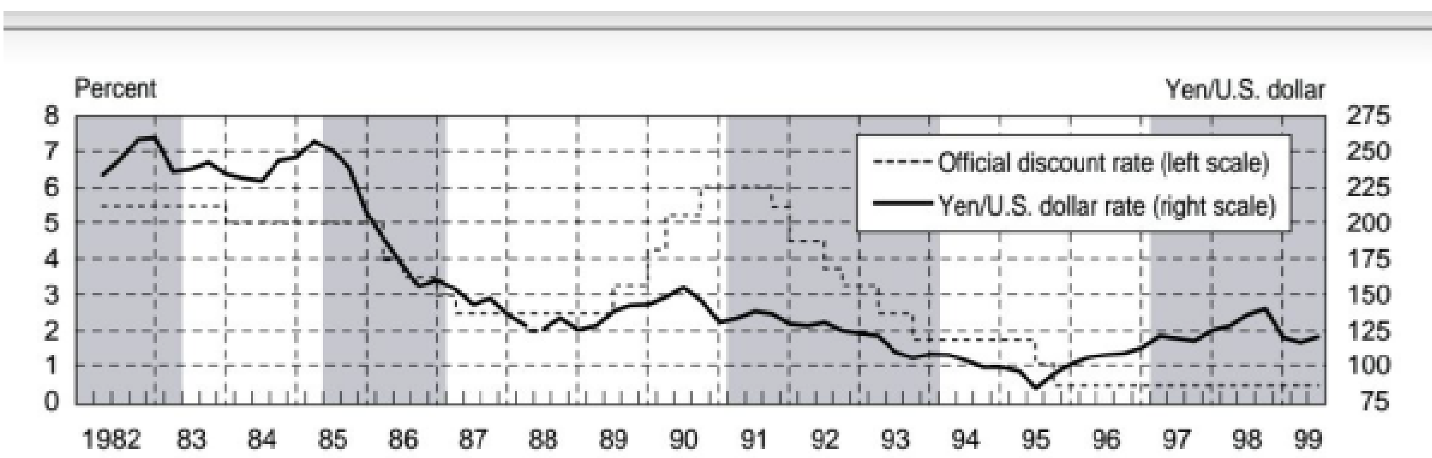
Mechanism: The current account surplus countries (Japan and Germany) would boost domestic demand and appreciate their currencies. In effect, the Federal Reserve would allow the dollar to decline, and focus more on growth after signalling that after a long and successful fight against inflation. USA was having positive growth rate with high valued currency (see graph) and trade deficit. Interest rate and inflation was low.{since in the mid- to late-1970s, when inflation surged to double-digit levels, it created a great unrest in people and was considered biggest enemy.}. Thus, devaluing the dollar would reduce trade deficit and make the American products more competitive in international markets, helping to develop growth and rejuvenate the local industries.

Fig 5 : Inflation - Consumer Prices



Source : Google Public Data

Fig 6 : Yen/USD exchange rate(1982-99)



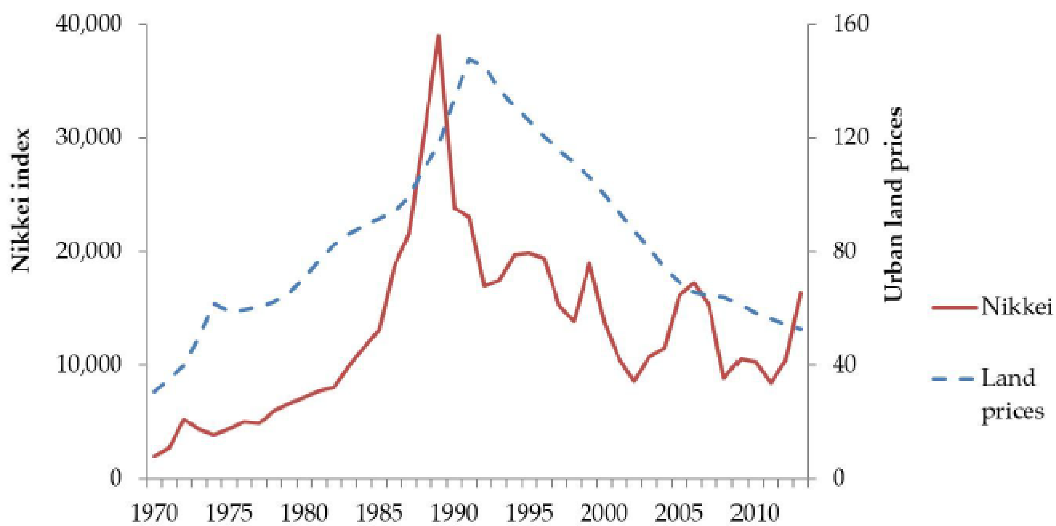
Source : http://www.imes.boj.or.jp/research/papers/english/me-s1-14.pdf

7 The Rise of the Bubble (1985-1990)

First of all, Lets focus on the monetary policies of BOJ during the time of bubble formation.

7.1 Monetary easing* and growth of asset prices

Fig 7



Source : http://www.imes.boj.or.jp/research/papers/english/me19-s1-14.pdf

The Japanese government was very concerned about the appreciation of yen as it was causing it huge losses in the export. To stop the further appreciation of yen what bank of Japan did is that it lowered the discount rates(repo rates) so that the money flow can be increased to stop the further appreciation of yen. The discount started dropping from January 1986 from 5% and were dropped in five stages to 2.5% till 1987.

***Monetary Easing** : Monetary easing is monetary policy in which a central bank purchases government securities or other securities from the market in order to lower interest rates and increase the money supply and thus, stimulate the market activity.

Fig 8

Effective date	Official discount rate	Notes
January 30, 1986	5.0 percent → 4.5 percent	
March 10, 1986	4.5 percent → 4.0 percent	The announcement date was the same as that for the reduction of official discount rate by the FRB and Bundesbank.
April 21, 1986	4.0 percent → 3.5 percent	The effective date was the same as that for the reduction of official discount rate by the FRB.
November 1, 1986	3.5 percent → 3.0 percent	A joint announcement on the stability of foreign exchange rates by Finance Minister Miyazawa and Treasury Secretary Baker was published when the BOJ's reduction of official discount rate was put into effect.
February 23, 1987	3.0 percent → 2.5 percent	The Louvre Accord was agreed on the announcement date of the BOJ's reduction of official discount rate.

During this monetary easing, bank got the opportunity to lend more and more money as more people were able to afford the loan at such low prices. But the thing is the Japanese bank were losing their big customers (firms) because of the equity and bond market growth and investment. So they started lending to the customers they shouldn't. As nothing effective was done in financial regulation,it also aided the practice of ill lending.

Now why were the Japanese government not regulating effectively?, well one of the reasons might be that as the bank and brokers had a very good relation with the financial department of government because after their retirement they would be looking for the really good job like working in big financial firms so they Japanese officials kept good relations with the firms and banks and didn't do much in the regulation.
The asset prices began increasing in 1983, and it was around 1986 when the rise began accelerating rapidly. Among asset prices, what exhibited the most rapid rise initially were

stock prices.The speed of the rise in the Nikkei 225 began accelerating in 1986. The rise in land prices followed that in stock prices with a time lag, spreading from Tokyo to major cities such as Osaka and Nagoya, and then to other cities.

7.2 Seeking for Monetary Tightening

In around 1987, BOJ saw that the economy is growing at such rate which could not be sustainable in future. Although the BOJ sought an appropriate timing to tighten monetary policy during this sub-period, it could not easily shift to monetary tightening, thus resulting in the then lowest official discount rate being maintained for a protracted period. The lowest discount rates continued for about two years and three months from February 1987 to May 1989. There were some reasons behind the delay of the monetary tightening. One of them was, after the meeting between Prime Minister Nakasone and President Reagan in May 1987 referred to the BOJs short-term interest rate operations it was decided to further decline short-term interest rates (the monthly average overnight unsecured call rate fell from 3.52 percent in April to 3.17 percent in May). Finally, the BOJ took the first concrete step to change its monetary easing stance at the end of August 1987 when it began guiding market interest rates to a higher level. As a result, short-term market rates gradually rose after September and, on October 19, immediately before Black Monday incident.

Black Monday (19 October 1987) was the day when the huge loss in stock market was observed worldwide started from Hong Kong then to Europe and then hitting the USA market after affecting the other countries market. The financial institution and foreign bank were unstable so the interest rates were kept low.Black Monday resulted in the BOJ suspending monetary operations to guide interest rates to a higher level, and short-term rates declined again. Under such circumstances, the maintenance of low short-term interest rates was mentioned in the joint statement issued after the meeting of Prime Minister Takeshita and President Reagan in January 1988. So due to such factors the monetary was delayed till 1989.

7.3 Monetary Tightening

It was in May 1989 when the official discount rate was finally raised from 2.5 percent to 3.25 percent. In raising the official discount rate, the BOJ strongly emphasized that it was a preventive measure against inflation. The economy expanded rigorously even after the official discount rate was raised. Therefore, the official discount rate was raised again in October and December 1989, by 0.5 percentage point each time, and then two more times in March and August 1990. The two hikes in 1990 were relatively large, one percentage point in March and 0.75 percentage point in August. The growth of money supply accelerated even after the official discount rate was raised and reached a peak in the second quarter of 1990. Stock prices continued to rise until end-1989, and in 1990 plummeted with a few rebounds on the way. After the official discount rate was raised in August 1990.

The most important point in considering the relationship between the emergence of the bubble and monetary policy is that as low interest rates were maintained under economic expansion, which led to strengthening the effects which led to rise in asset prices.

Now lets look at the other factors which played major role in the formation of bubble.

7.4 Aggressive Behaviour of Banks

The restrictions on fund-raising in the securities market by firms were removed from around 1980 and the bank became very concerned that major firms would become less dependent on them for funding. The deregulation of interest rates on deposits proceeded gradually,forcing banks to pursue such aggressive lending as loans to small firms backed by property and also property-related loans. It is confirmed that many failed banks aggressively expanded their loans to property-related firms from the mid-1980s. As there was not much done in discipline regulation by the Japanese Government , it gave the banks full freedom to lend more and more money on land as collateral and they even gave the loans to customers which were not really promising in returning the loans but as most of them were by the real estate the bank have no idea that they could face losses as the prices of real estate was rising very rapidly and were expected to follow the same behaviour in future.

7.5 Taxation and Regulations

The taxation and regulations on land were biased toward accelerating the land prices. The tax rates were relatively low on the holding of land but heavy on land transactions. When a rise in land prices is anticipated, the light tax burden on holding land has the effect of increasing the incentive to continue holding it, which thus suppresses the supply of land. There were heavy tax burden on transaction gains creating an incentive to delay selling it for as long as possible.

Monetary easing could also lead to rapid increase in asset prices. A rise in stock prices, partly supported by monetary easing, reduced capital costs and facilitated financing in capital markets. A rise in land and stock prices increased the value of land and stocks held by firms which increased the funding ability because of increase of collateral values of assets.

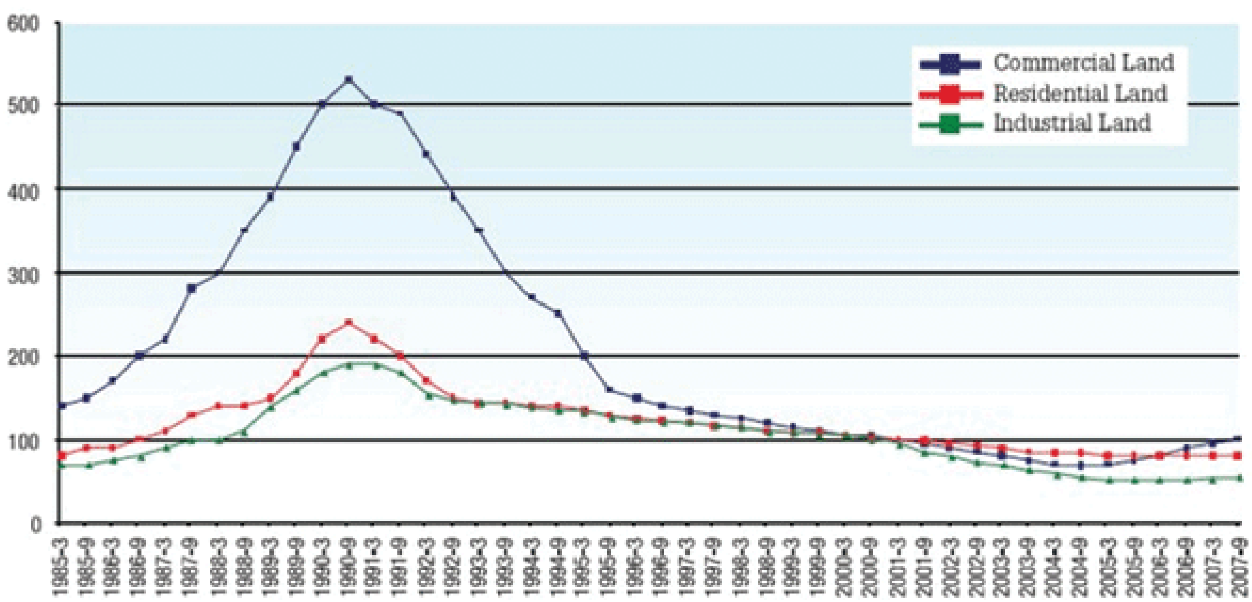
7.6 Overconfidence and Euphoria

Japan was very confident in itself because it has done well even when the world has suffered financial crisis. The thought that Japan has always found its way back and it was different was totally bullish.The greater role of Japan in international financial markets and the large-scale takeovers of foreign companies by Japanese firms give them the feeling of becoming the great economy. Japanese firms were leading the world in manufacturing technology,including semiconductors, and the success of Japanese-style management was also one the factors which Japan thought that it could sustain such high growth without very high risk.

8 Bubble Burst and the Lost Decade

In 1989, the process was monetary tightening started which made few made few ups and down in stock market but it was in 1990 when the stock market totally crashed falling to 21000 points which was around 37000 points in January 1990. After the crash of stock market, the land prices started falling in 1991.The asset price burst seemed to exert a strong impact on the overall Japanese economy. By 1992, urban land prices nationwide declined 1.7% from the peak. However, the impact was worse for land in the six major cities, as the average land prices (commercial, residential, and industrial) dropped 15.5peak. Commercial, residential and industrial land prices dropped 15.2%, 17.9%, and 13.%, respectively.The entire crisis also badly affected direct consumption and investment within Japan. As a result, from a prolonged decline in the asset prices, there was a sharp decline in consumption, which resulted in long term deflation in Japan. The asset price burst also badly affected consumer confidence since a sharp dip reduced household real income.The banks were in huge losses due to accumulation of huge non-performing loans. As most of the banks gave huge loans backed by property and now the prices of land were falling, it also made the value of the assets kept by banks as collateral decreasing. At this time the Japanese Government was totally aware that their economy was in huge danger and loss.

Fig 9



X axis : Years, Y axis : Land Price Index

Fig 10

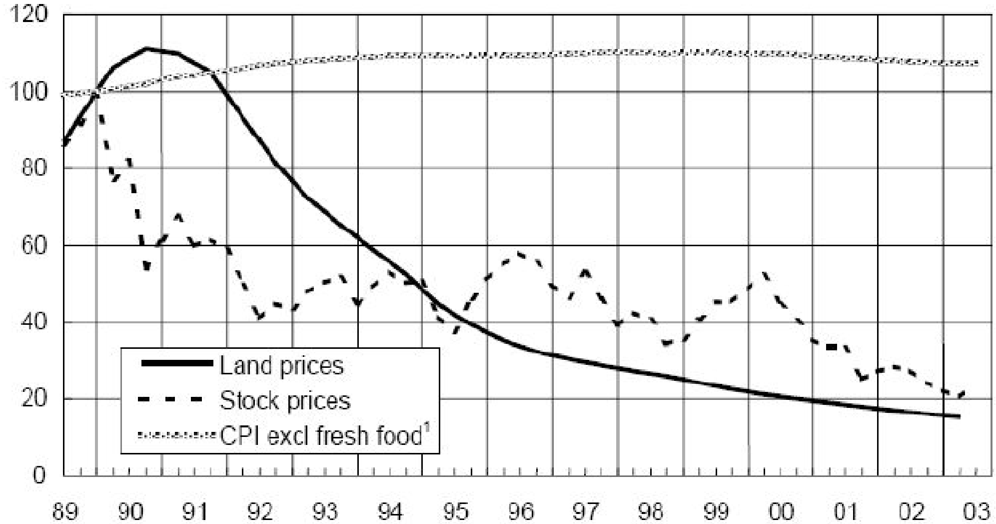
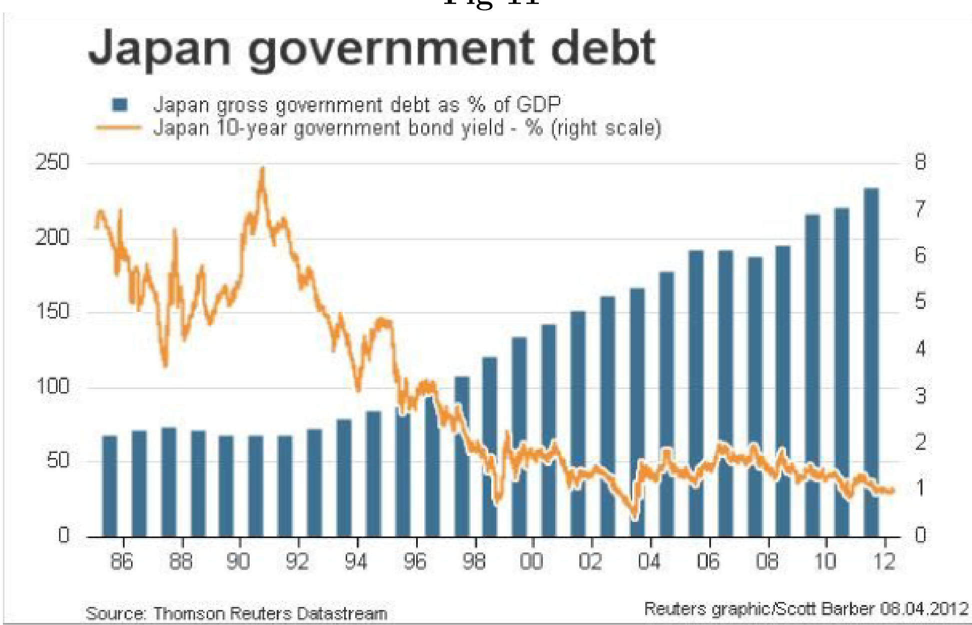
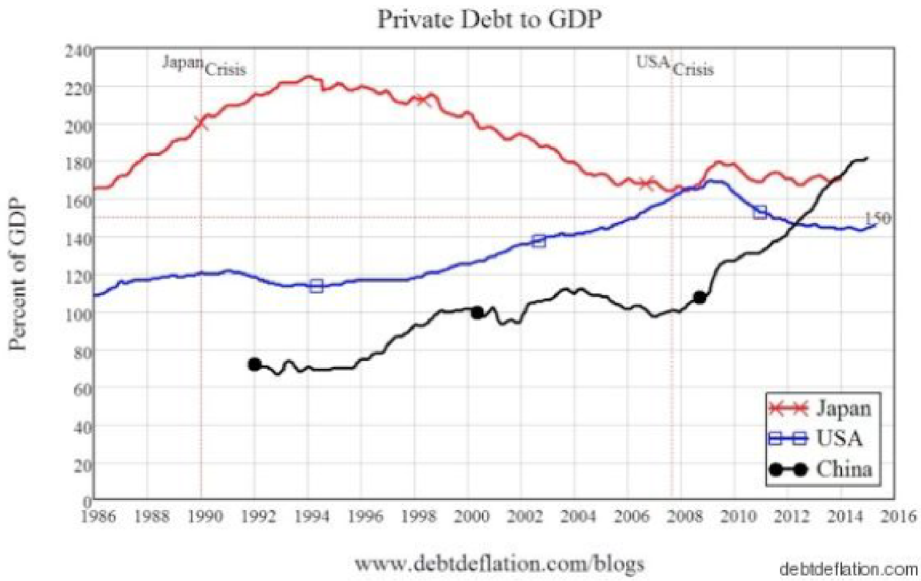


Fig 11



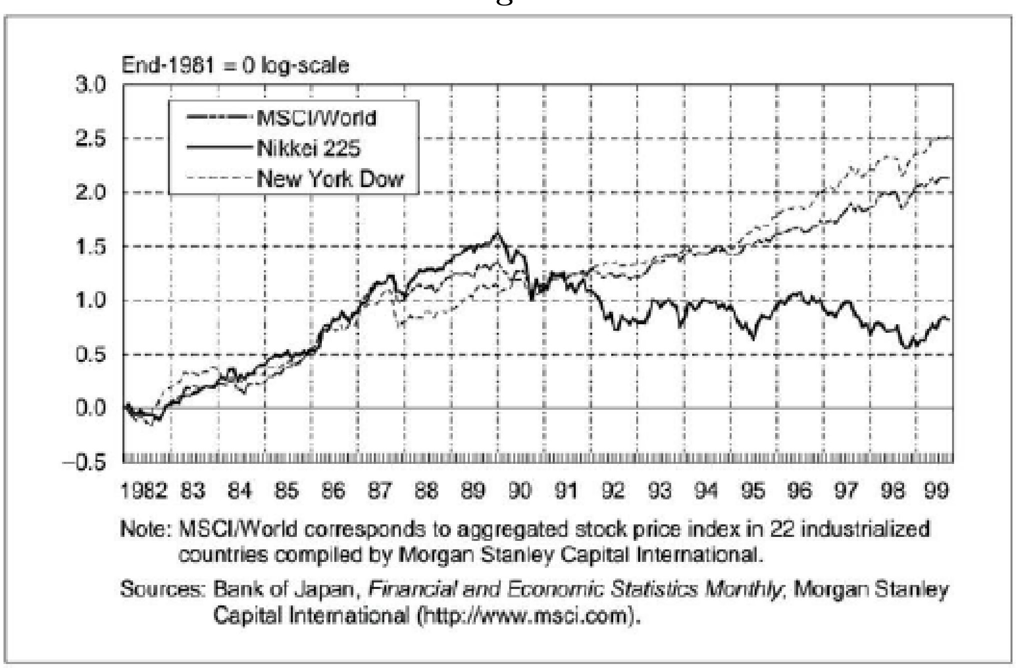
After this the era of low GDP growth rate and stagnant economy started in Japan which continued till 2000s also known as the Lost Decade. After that no matter whatever policies the Japanese government tried but it seems that Japanese economy was stubborn and become unresponsive. Japanese lost the trust on bank and they were keeping the money with themselves rather than putting in the bank as they thought the banks are unstable. They were only willing to invest in the government securities which gave government money to invest on welfare sector like building dams, bridges and other public goods to create new jobs and pump money into the economy but it had the short term effect. The policies of Japanese Government were proved to be ineffective. There were social impacts too. The people of Japan felt like they were left alone in such hard times. The Japanese felt that government was unresponsive and ineffective and they lost their interest in politics.

Fig 12



The policies were finally changed in 2000s when Japanese Government decided to bailout the banks by taxpayer money so that huge debts of banks can be cleared and the money supply could increase. The people could again get confident in bank and investments could be increased.

Fig 13



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