# RESEARCH SEMINAR IN INTERNATIONAL ECONOMICS

School of Public Policy The University of Michigan Ann Arbor, Michigan 48109-1220

Discussion Paper No. 485

# Japan's Lost Decade: Origins, Consequences, and Prospects For Recovery --

**Chapter Abstracts** 

Gary R. Saxonhouse and Robert M. Stern, eds.

University of Michigan

August 22, 2002

Recent RSIE Discussion Papers are available on the World Wide Web at: http://www.spp.umich.edu/rsie/workingpapers/wp.html

#### The Bubble and the Lost Decade

# Gary R. Saxonhouse and Robert M. Stern

#### ABSTRACT

In this overview of the Symposium papers, we note that the bubble that occurred in Japan's asset markets in the late 1980s came at a time when the conventional indicators of Japan's economic performance were relatively stable. Following the collapse of the bubble, neither the Bank of Japan (BOJ) nor the Ministry of Finance (MOF) took timely and effective measures to deal with the recession that followed. While the evidence suggests that looser fiscal policy would have been ineffective, monetary policy measures might have worked. However, the BOJ followed a relatively tight monetary policy in 1991-93.

In the face of the liquidity trap that ensued in the last of the 1990s, the conventional tools of stabilization policy appeared to be of limited use. To help the Japanese economy to recover from the "lost decade," we thus discuss a number of unconventional and bold measures that the BOJ and MOF could pursue. It appears, however, that the political will is absent to undertake such measures. So long as this is the case, the effects of the lost decade will continue to act as a drag on the economy.

Retrospective on the Bubble Period and Its Relationship to Developments in the 1990s

#### Takatoshi Ito

#### ABSTRACT

In reviewing what happened in the 1980s in Japan and how the bursting of the bubble created problems in the early 1990s, the following conclusions are obtained. (1) In order to limit damage to the economy from a bubble and its bursting, it is important to build a resilient financial system through strict supervision policy, so that asset-price fluctuations would not weaken financial institutions. Supervision policy would include regulatory measures limiting lending concentration and exposure to real-estate-related sectors. (2) Monetary policy should pay attention to asset-price movements. But it may be difficult and inappropriate to raise the interest rate sharply when inflation is low (below 1 percent like in Japan), even though asset prices are increasing at 30-40 percent. (3) The official discount rate could have been raised in the summer of 1988 in Japan, when the Federal Reserve and Bundesbank raised interest rates. This would have slowed down the rise of stock and land prices, but the bubble was already large by then. (4) The bubble in the second half of the 1980s was only partially responsible for the lost decade of the 1990s in Japan. A series of policy errors made a small problem of the burst bubble much bigger than necessary.

# Why Does the Problem Persist? "Rational Rigidity" and the Plight of Japanese Banks

# Kiyohiko G. Nishimura and Yuko Kawamoto

# **ABSTRACT**

One of the most perplexing factors in the Japanese financial crisis is the apparently non-optimal and non-rational behaviour of Japanese banks. We provide a "rational" explanation for bank behaviour based on a theory of community banking that incorporates Japanese institutional characteristics. We find three implications of community banking - a low lending rate, a low bankruptcy rate, and in particular, institutionalisation of "rational rigidity" (an institutional pledge of no profit maximization) – in Japanese banks. We argue that this type of banking is viable as long as the economy expands and asset prices go up, which was the case before the assetmarket crash in 1990. The stagnation and free-fall of asset prices in the 1990s exerted tremendous pressure on Japanese banks but did not paralyse them completely in the 1990s, although there are indications that they failed to restructure distressed large corporations in some sectors, notably real estate. Thus, the problem is not that paralysed banks are blocking recovery, but that their current institutionalised rigidity in banking practices is no longer viable because private enterprises in the market economy are suffering from asset-price deflation and economic stagnation.

# Japan's Fiscal Policies in the 1990s

Toshihiro Ihori Toru Nakazato Masumi Kawade

#### ABSTRACT

This paper first summarizes Japan's fiscal policies in the 1990s. Then, we investigate the macroeconomic impact of government debt and the sustainability problem. We find that the Keynesian fiscal policy in the 1990s was not effective and fiscal sustainability may therefore become a serious issue. We also estimate the optimal level of deficits and evaluate fiscal reconstruction movements. It is shown that the actual deficit exceeded the optimal level in the late 1990s. We then inspect fiscal reconstruction movements in the Hashimoto Administration in 1997 and find that the major factor of recession in 1997 was not fiscal consolidation. An important lesson from Japan's fiscal policies in the 1990s is that long-run structural reform is more important than short-run Keynesian policy.

# Japan's Negative Risk Premium in Interest Rates: The Liquidity Trap and Fall in Bank Lending

# Rishi Goyal and Ronald McKinnon

#### ABSTRACT

Japan's interest rates have been compressed toward zero because of pressure coming through the foreign exchanges. Twenty years of current-account surpluses have led to a huge buildup of claims – mainly dollars – on foreigners. Because of ongoing fluctuations in the yen/dollar exchange rate, Japanese financial institutions will only willingly hold these dollar claims if the nominal yield on them is substantially higher than on yen assets. In the 1990s to 2002 as U.S. interest rates have come down, portfolio equilibrium has been sustained only when nominal interest rates on yen assets have been forced toward zero. One consequence is the now infamous liquidity trap for Japanese monetary policy. A second consequence is the erosion of the normal profit margins of Japan's commercial banks, leading to a slump in new bank credit and an inability to grow out of the overhang of old bad loans.

# Japan's Lost Decade and Its Financial System

#### Mitsuhiro Fukao

#### ABSTRACT

After briefly explaining the causes of the Japanese asset-price bubble in the 1980s, this paper analyzes why the bursting of the bubble developed into a full-fledged financial crisis in the late 1990s. In order to cope with this crisis, the Government has injected capital directly into the banking sector and banks have written off enormous amounts of bad loans. However, the Japanese financial sector remains very weak and Japan still faces a number of problems in its financial system.

Firstly, the profit margin of banks is too small to cover the increased default risk following the bursting of the bubble, and there are market distortions created by the government-backed financial institutions and the requirements on new lending to small and medium sized companies. Secondly, banks still have excessive stock investment and crossholding of shares between banks and other companies has weakened the market discipline on entrenched management. Thirdly, the government guarantee of all banking-sector liabilities should be removed. Once the financial system is stabilized, a risk-adjusted deposit insurance premium should be introduced so as to strengthen market discipline on banks, and the huge postal saving system should be privatized to create a level-playing field among deposit taking financial institutions.

Besides the foregoing, the weak corporate governance structure of Japanese financial institutions has to be remodeled. The management of banks has shielded themselves by extensive cross-shareholdings, especially with life insurance companies. There has been extensive mutual provision of capital, most large life insurance companies

have weak corporate governance, and many of the large shareholders of banks are life insurance companies. This double gearing between banks and life insurance companies has therefore weakened the market control of Japanese financial institutions.

KEYWORDS: Japan's Bubble Economy; The Lost Decade; Prospects for Recovery