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Romanian Economic and Business Review – Vol. 2, No. 2

JAPAN’S ECONOMY FROM BOOM TO BUST

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Abstract

Japan’s economic evolution for the last half of the century provides us with an unique occasion to test alternative theories for growth. This short article makes a review of the main economic events and their causes. It maintains that behind Japan’s slump and deflation was the state policy which encouraged a prior unsound expansion.

Japan’s economy boosted after World War II to reach the second position in the world. Many people expected Japan to become the first player in the world economy by the end of 20th century. However, this prophecy vanished in the bust that ocurred in the 1990s.

The fascination of “japanese miracle” lead to the writing of many books and articles attempting to explain the reasons behind this formidable economic growth – Eric Vogel, *Japan as Number One*, William Ouchi, *Theory Z*, Eisuke Sakakibara, *Beyond Capitalism*, Herman Kahn, *The Emerging Japanese Superstate* etc.

Some economists believe that a strong work ethic as well as high saving and investment rates were decisive for Japan’s ascension in the top developed countries. Others think that state intervention in industrial development and export planning were the crucial element of this development.

As a matter of fact, “Japan has experienced both the genuine miracle of the market and the counterfeit miracle of the state for the past 150 years.” (herbener, 1999) after the world war II, the economic growth became so impressive that the expression “japanese miracle” was quickly adopted by professional analysts.

The real economic growth for three decades prior to the 1990’s was substantial. the 1960s marked 10% average growth, the 1970s with 5% average growth and the 1980s with 4% average growth.is the enlightened dirigisme of japanese government responsible for this record? As lal (2002) argues, the investment rate and the quality of the labor force are better explanation for this evolution.

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In the 1990s, economic growth was much smaller due to over investment in the 1980s and contractionary government policies. In 1996, growth increased in response to expansionary fiscal and monetary policies. However, despite the temporary increase, japan entered a recession starting in 1997. The economy began to stabilize in 1999 as fiscal and monetary policies increased government spending and improved business confidence. However, in 2001, japan finds itself again with a decline in industrial production, the sharpest since 1993, and an economy in recession.

But more important than simple calculations of GDP is how efficient are resources used in producing the goods that subsequently become part of GDP. According to Deepak Lal, between 1970 and 1998, the net savings of japanese households amounted to 1250 trillion yen. At the same time, the change in net worth for this sector during the same period was 860.7 trillion yen. Put it differently, japanese households lost almost a third of their savings. What is the explanation for this huge loss? The reason seems to be the huge rate of investment, or rather overinvestment, made by japanese firms which, in time, proved to be less and less efficient. Thus, for example, in 1996, the same author quotes an estimate of the rate of return of only 1.6-2% for the overall economy. This rate of return to capital fell from the level of 12% in the 1952-1973 period.

Besides decreasing returns to scale, a second important factor for the declining rate of return was the monetary expansion engineered by Japan’s government. Unsustainable credit expansion has led to malinvestments because the artificial decline of the interest rate has stimulated the adoption of investment projects with lower returns.

This event has its roots in the accommodative monetary policy pursued by the Bank of Japan (BOJ) in the mid-1980s following the Plaza Accord. The BOJ sought to stem the appreciation of the yen, which hurt its heavily export dependent economy. Rather than allow market forces to rearrange the pattern of production along more sustainable lines, the BOJ began its aggressive campaign to bring down the yen.

Meyer (2004) offers a good historical record of the effects of this policy. The BOJ reduced the interest rate from 5% to 2.5% between January 1986 and February 1987, a 50% reduction. The result was an uncontrollable expansion, as the stock market scorched its way upward. From January 1985 to its peak in December of 1989 (based on month-end index prices), the Nikkei nearly tripled. From 1986 through 1990, Japan's money stock grew by an average of 10.5% per year.

The BOJ inflated the yen money stock by 10.5% per year from 1986-1990 and lowered the discount rate from 5% in 1985, where it had been since 1983, to 2.5% by 1987. Japan exported the credit expansion to Southeast Asia and South Korea in the form of direct investment. The massive Japanese investment in Asia was augmented by loan guarantees made by the Export-Import Bank of Japan for investment in and trade with Asia. By the end of the debt binge, Japan was the world’s largest creditor nation manifested by having the world's largest banks and had the stock market with the world’s largest capitalized value.

Despite the massive yen inflation, the yen appreciated 50% against the dollar from the beginning of 1985 to the end of 1988 and consumer-goods prices in Japan rose only 0.5% per year while wholesale-goods prices fell 4.6% per year indicating that growing yen money demand, international as well as domestic, was absorbing the monetary inflation. But supremacy of the yen was short-lived. Yen demand collapsed in 1988-1989 causing a 16% devaluation against the dollar and a surge of domestic price inflation.

The BOJ reversed its policy, and abruptly reduced inflation from 12.1% in 1990 to 4.1% in 1991 and then to 1.2% in 1992. The discount rate was raised five times, from 2.5% in 1988 to 6% by 1990. The end of the credit expansion doubled interest rates while the reduction in yen inflation helped push up the yen-dollar exchange rate 22% from 1989-1993. From a peak of 40,000 in December of 1989, the Nikkei tumbled to a low (again, based on month-end prices) of 7,831 in April of last year – a drop of 80%.

“Japan had experienced what America discovered in the wake of the collapse of Bretton-Woods: generating an international credit expansion succeeds so long as increases in money demand keep price inflation in check. Japan’s restoration of a yen trading-block in Asia was cut short by America reasserting the dominance of the dollar, first in Canada, Mexico, Latin America, and South America and then in Asia and eastern and central Europe. The yen had little chance against the world’s reserve currency and the yen-based credit expansion collapsed in 1990.” (Herbener, 1999)

The Bank of Japan attempet to inflate again in the 1990s. Despite the fact that the discount rate was lowered from 6% in 1991 to 0.5% by 1997, the banks refused to expand credit and instead simply absorbed the new money to hold as reserves against bad loans. As Herbener (1999) further explains, “blocked from domestic credit expansion, the BOJ tried to expand Japanese bank credit overseas with the yen carrying-trade. Investors borrowed yen at low interest rates, converted the yen to dollars and other currencies and bought higher-return assets overseas. This put downward pressure on the yen which increased the profitability of the strategy. The yen carrying-trade was active from mid-1995 to mid-1998 as the yen fell 83% against the dollar, but in July of 1998 the yen began to appreciate again, losses ensued and the trade dried up. This policy exacerbated the financial debacle in Asia by greatly expanding credit for three years and then suddenly shutting it off. The financial debacle in Asia then saddled Japanese banks with more foreign bad debt. In response, they cut foreign lending in the first quarter of 1998 by $244.3 billion or 12%. This cut is the latest in a downward trend that has left the once dominant Japanese banks with the same global market share that they had in the early 1980s.”

In fact, banks stopped performing their natural role of financial intermediaries. Almost all the additional funds they acquired need to be used to pay down bad loans instead of expanding credit. From 1995-1998, bank bad loan write-offs were $300 billion while banks reduced their loans 2.7% from September of 1997 to September 1998 and another 5.4% from May 1998 to May 1999. This is why enormous increases in the monetary base, 10% from mid-1997-mid-1998, have had little effect on broader monetary aggregates, which rose only 3.5%. Critics state that the root of Japan's banking problem is poor lending decisions. Since the 1990s banks have written down almost twice their entire capital and reserves to eliminate the bad debt.

Japan spent huge amount of public funds to prevent the economy from declining further. In 1995, the BOJ dropped its discount rate to 0.5%. In 1998, two spending packages worth 40.6 trillion yen were revealed. In 1999, came yet another fiscal stimulus package, this one worth 18 trillion yen. In 2000, another 11 trillion. Much of this deluge of money was put into public works projects or funneled through to politically favored businessmen. Japan's finances weakened as its debts grew.

Another determinant of the economic problems affecting Japan is the low return of its foreign investment. Japan's has become the largest creditor in the world, but unlike past big creditor nations – like Great Britain in the XIX century and USA in the XX century – it does not have a leading world currency. In other words, Japan has not used its currency to invest abroad, and consequently has borne to exchange rate risk. "With the dollar depreciating against the yen, their returns on foreign investments have been virtually wiped out over the 1980-1990's." (Lal, 2002)

What could be said in the conclusion of this article. It is best perhaps to quote again from Lal (2002):

"In fact, the much touted Asian model of development – which combined an unholy alliance between parts of the government, large industries and the banking system – stored up the troubles which have led to the continuing slump. Because of the mral hazardcreated in such an economic system the financial system comes to be stuffed with more and more bad paper, as industrialists overinvest and undertake increasingly dicey investments. The bursting of the 1980's asset bubble has merely brought these chickens home to roost. What Japan needs is action to not merely clean up the ensuing financial mess but to turn its back on this doomed model."

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