

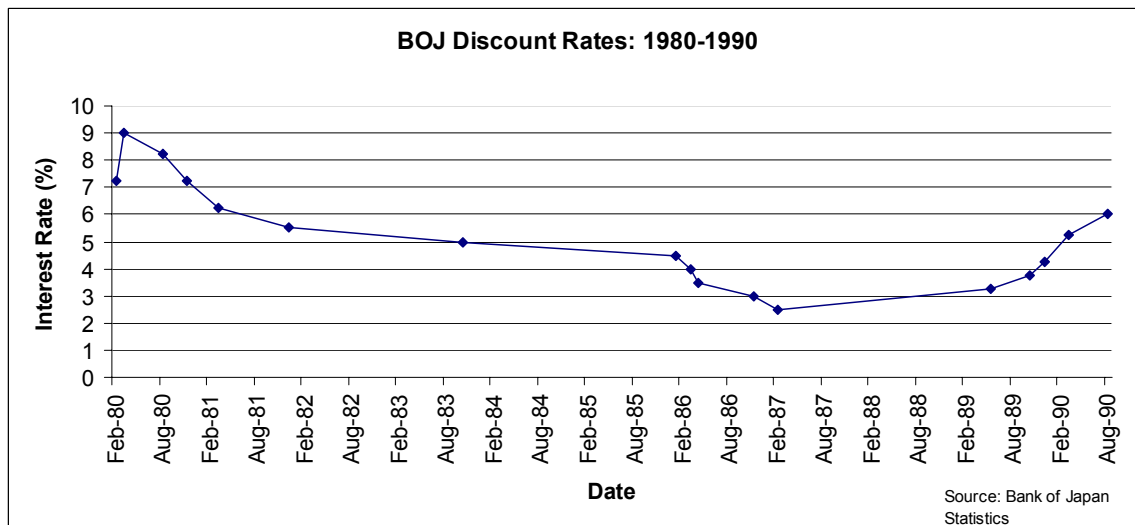
The Cause of Japan's Boom and The Reasons for Its Prolonged Bust

Japan's asset bubble and its subsequent burst from the late 1980s through the 1990s looks like an eerie portent of what may be in store for the United States. In both cases, and as with many crises, people tend to look at the symptoms of the events rather than their root causes. However, if we do not look at the root causes, we will never learn why the mistakes were made. Thus, in this paper I will look at the root cause of Japan's asset bubble, and also the reasons its bust was so prolonged. I will provide an Austrian critique of the cycle, that the Japanese asset bubble was largely caused by government policy, and that it was in fact more government intervention that contributed to Japan's staggeringly long economic downturn. While the complexity of Japan's economic system may have been great, I believe the root causes of its problems were quite basic.

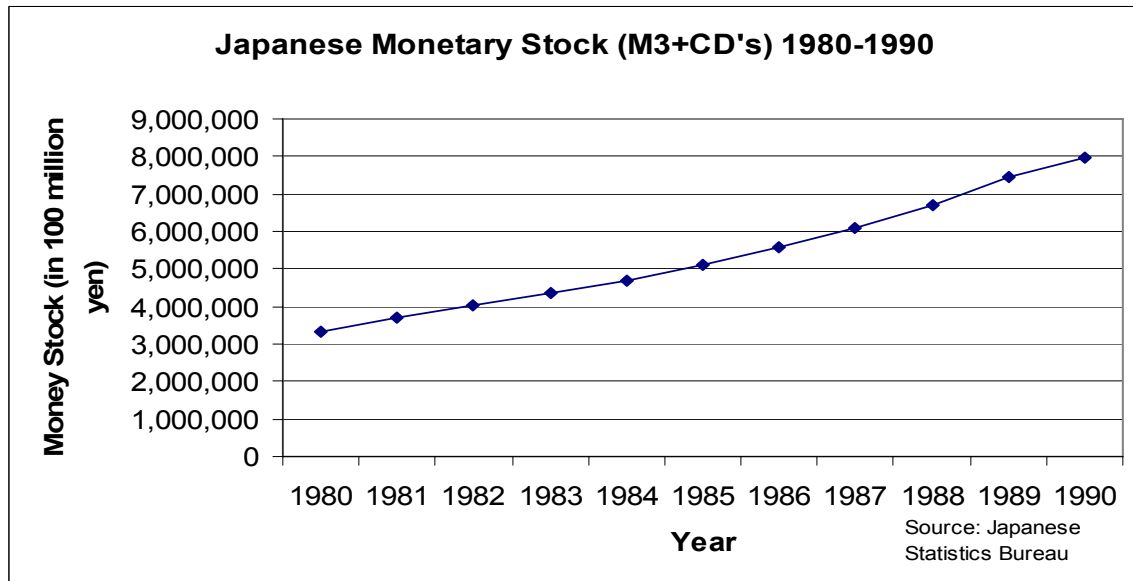
In order to understand the dynamics of Japan's cycle, I will reference the Austrian theory of the business cycle. The Austrian economists argue that the boom and bust cycle is a natural outgrowth of government intervention in the markets through the central bank. The central bank attempts to stimulate economic growth by lowering its interest rates, increasing the money stock which encourages banks to lend out money to businesses or consumers. The consumers spend and businesses invest. Ideally, the central bank is able to turn off the monetary spigots when sufficient credit is produced for desired consumption and profitable projects, and the bank raises its rates to cool growth. The problem with this is that according to the Austrians, no group of central bankers has the ability to factor every variable in to select the "natural" rate of interest, or the "rate that governs the allocation of resources between current consumption and investment

(consumers' time preference) for the future,” (“Natural and Neutral Rates in Theory and Policy Formation”). The boom occurs when the central bank holds rates below the natural rate, incentivizing consumers and businesses to spend or invest in more unnecessary or riskier ventures than they would were the cost of money at its natural level. The Austrians refer to this as malinvestment. As the money is spent or invested, this leads to a general rise in prices, though often more-so in particular sectors. (Rothbard, 9-14). This is exactly what occurred in Japan, specifically in the financial and real estate sectors. The bust occurred when Japan raised its interest rates (Grimes, 2). I will describe this in detail in the following paragraphs.

When we look at the case of Japan, it represents a classic example of the Austrian theory of the business cycle. Below I show Japan's interest rates from February of 1980 to August of 1990:



As one can see, there is a secular trend of lower interest rates from early 1980 through early 1989. As one might expect, the monetary stock increased at a year-over-year rate of 9.07% as depicted below:



So what are the implications of this data? As Christopher Wood notes, Japan's bubble was fueled by cheap and super easy credit (2). Japan's gross consumer debt increased seven-fold from 9 trillion yen in 1979 to 67 trillion in 1991 (2). Per capita consumer debt reached \$2985 in Japan, just below the \$2915 of the US (2). Between 1985 and 1990, Japanese industrial companies raised some 85 trillion yen (\$638 billion) through the stock market, at what were essentially free financing levels, fueling the biggest spending spree since 1945 (6). These were companies that made up the real industrial economy. In terms of the stock and real estate markets, the numbers were even more staggering. According to what Wood aptly describes as the unstable liquidity-triggered boom, at the height of the bubble the stock market's capitalization made up 42% of the entire global market's capitalization, when in 1980 it had made up a comparatively meager 15%; Japan's market worth had increased to 151% of GNP, from 29% in 1980 (8). Land values in 1990, even after the stock market crash were still five times Japan's GNP (8). Japan's lax monetary policy led it to become the marginal supplier of world credit, acting as the lender and purchaser of last resort (8). So why did

Japan lower its interest rates between 1986 and 1987 to 2.5%, a historical low? Japan's central bank took on a loose monetary policy partially at the behest of the US government which convened the G7 at the Louvre Accord in 1987 in order to stabilize international currency markets and halt the slide of the US dollar (20). As you'll note in the earlier graph of interest rates, Japan's cut to 2.5% coincided with the Accord in February of 1987.

The slide in interest rates during the 1980s led to major and unsustainable increases in asset prices, as the easy credit incentivized people to take on more debt and companies to invest in riskier ventures than they would have were the interest rates reflective of the time preferences of the Japanese. Many have attributed the boom to a handful of other factors as well. For example, in a report published by the BOJ, economists argue that aggressive lending, deregulation of deposit rates, cross-shareholdings amongst financial institutions, and inflation in land prices because of tax policy and zoning regulations all contributed to the boom. (Okina, 412; 416-417). Others have contended that the boom was caused by group-think and the pervasive belief that market prices would rise forever (Wood, 7). To be sure, all of these things negatively impacted Japan, but I would argue that they were generally mere symptoms of the lax-interest-rate-fuelled boom.

Banks would not have lent as aggressively were it not for the major amounts of liquidity provided by the government. Deregulation meant that Japanese banks would have to compete in a world where capital raising was determined by providing the cheapest capital, not political clout. Liberalization certainly proved cruel to a financial system that had been largely socialized, but this I would argue is more a reason for

Japan's bust then cause of its boom. Significant cross-shareholdings of financial institutions helped prop up the value of companies, allowing them to avoid the discipline of stock market investors and creditors, but again, the high valuations were reinforced by the liquidity boom. Finally, the tax policies and zoning regulations certainly kept the prices of land high, but I would argue that supply and demand fundamentals, even altered by these distortions, could not account for such a huge run-up in real estate valuations. Only a credit-fuelled boom could do this. Finally, every speculative boom is marked at its height by the rush of the masses to capitalize on opportunity. However, as with almost all of these other factors, I would argue that this is a symptom of the boom rather than a cause.

Ultimately, the bubble was pricked, as the Japanese monetary authorities aggressively raised interest rates in from 1989 to 1990. The bust created great carnage. From a high of 40,000 in 1989, the Nikkei fell to a low by 1999 of 7,831, an 80% drop. From 1991 to 1998, real estate prices dropped by 80% as well (Powell, 36). Unemployment rose from 2.1% in 1991 to 4.7% in 2000. As the Austrian economists note, following a bust, the best the government can do is encourage the liquidation. Liquidation allows the malinvestments to be wiped out of the system, and leaves the economy fundamentally sound and able to renew real sustainable growth (Rothbard, xxvii). The worst the government can do, and incidentally its most common measures for fighting the recession include: preventing or delaying liquidation, inflating further, keeping wages up, keeping prices up, stimulating consumption and discouraging saving and subsidizing unemployment (Rothbard, 19-21). In the case of Japan, Ben Bernanke amongst others has argued that the reason for their prolonged struggles was a lack of

sufficient government intervention (Bernanke, 2-3). Yet Japan in fact followed practically all of the measures that the Austrians warned against as I will speak to in the following paragraphs. It is for this reason that I will argue that Japan suffered its “Lost Decade.”

Japan undertook a number of policies during the 1990s to breathe life back into the economy. Most of these initiatives were Keynesian. Keynesians argue that the reason for stagnation is a lack of consumption. Thus, in order to revive an economy, the key is to increase aggregate demand, often through public spending and tax decreases (“John Maynard Keynes”). In the decade from 1990 to 2000, Japan instituted 10 fiscal stimulus programs totaling more than 100 trillion yen. These stimulus programs generally took the form of public works projects or direct checks to the taxpayer. During this time, the government also cut income taxes in 1994 and temporarily in 1998, though this was offset by spending (Powell, 39).

The Japanese also attempted to reinvigorate the economy by significantly lowering interest rates, eventually to zero. However, while the rates dropped which should have led to an increase in borrowing, the money supply was not increasing. The Keynesians argued that Japan was stuck in a liquidity trap, where people were hoarding cash no matter how low the cost of borrowing (Bernanke 13-14). The Keynesians prescribed the solution of direct government lending. Through Japan’s FILP program, an off-government branch that controls around 70% of the spending in the general-account budget, the government lent to private institutions (Powell, 39). Paul Krugman, the Nobel-winning economist also prescribed “unconventional measures” to increase the money supply. Krugman advocated that the BOJ purchase dollars, euros and long-term

government to depreciate the yen. The BOJ's increased commercial paper holdings from 1997 to 1998 from zero to \$117 billion dollars ("Purging the Rottenness").

The government also undertook a number of other initiatives to fight the stagnation. It attempted to prop up the stock market when the Nikkei fell below 12,000 by purchasing shares of its publicly traded companies (Powell, 46). Japan developed a \$514 billion bailout fund for the nation's banks, with \$214 billion going towards direct purchases of shares of the companies and \$154 billion to nationalize, restructure and liquidate failed banks (Powell, 46). The government also tried to create an "orderly" decline in property prices in the early 1990s by imposing credit controls on loans, forcing banks' increases in outstanding property to grow more slowly than their increase in total loans (Wood, 53). Finally, in the late 90s the government set up a 20 trillion yen credit guarantee fund to provide debt availability for certain businesses (Powell, 46).

These policies while well-intended failed to bring the economy out of stagnation. In fact, they served to exacerbate many of the problems Japan already had, and created other ones in the process. First, Japan's undertaking of Keynesian fiscal stimuli led to the creation of a massive increase in Japan's public debt, as the debt by 2000 exceeded 100% of Japan's GDP (the highest of any of the countries in the G7 at the time) (Powell, 39). In "off-budget" sectors, even more debt was accumulated. The Austrians would argue that the last thing a country would want to do to during a time of recession is to become more fiscally irresponsible, yet this is what the Japanese did. That being said, public works projects can be beneficial when the government builds a good that the citizens demand. On the other hand, the Japanese undertook a variety of projects for the sake of creating jobs and generating economic activity. The problem with this lies in what Henry

Hazlitt calls the seen and unseen consequences of the project (“Public Works Means Taxes”). We see that a road is built, and that workers built that road. However, that road is financed either through taxes today, money to be taxed tomorrow when the government finances a project through a deficit or through printing more money which decreases the purchasing power of the money one holds today (thus effectively taxing through inflation). What goes unseen are the other commodities and products that that tax money would have been spent on were it not allocated to the road. As for the workers, we see the jobs produced, but we do not see the jobs in other industries that these workers might have taken. The funding and labor for the bridge at best is diverted from what it would be privately used for. At worst, it is used less efficiently than it would have been as dictated by the market. Wealth is therefore not produced by the project, but either diverted or destroyed (“Public Works Means Taxes”). Indeed wealth is often destroyed. As the *Economist Intelligence Unit* points out, "Generous Public works programmes have allowed many unviable construction companies to remain in business" (EIU, 40). I will return to this point later. The economic stimulus checks also represent the problem of the seen and the unseen. People see the checks they receive and the products they purchase. What they do not realize however is that by increasing the money supply in distributing the checks, the value of the purchasing power of their cash decreases. Thus, the economic stimulus ends up as a tax on the consumer as prices, *ceteris paribus*, will rise as the new money floods the economy.

As for the drastic lowering of interest rates in attempting to pump money into the economy, Japan’s central bank was merely attempting to reflate the economy by doing what it had done to cause the boom and bust in the first place. This amounts to giving an

alcoholic more drinks. Krugman's plan to devalue the yen provided a similar tonic and produced similarly nonexistent results. What the Keynesians missed out on however in their belief that inflation would help Japan out of its woes is that the falling prices they fought against, especially if they fell to market clearing levels were not inherently bad. For example, if we look at things like the computer or the television, while initially these products were luxuries reserved for the rich, now practically everyone can own them due to price deflation. The demand for these products was great, but the supply grew even greater, while the cost to produce the products fell, and so over time, the real cost of these products fell. In Japan, the problem was not a lack of consumption or "aggregate demand" that could only be countered by inflating, but rather as Dr. Benjamin Powell notes,

a structure of production that does not meet consumers' particular demands. Producing things that nobody wants and propping up malinvestments cannot possibly help any economy. This policy is equivalent to the old Keynesian depression nostrum of paying people to dig holes and fill them. Neither policy will revive the economy because neither forces businesses to realign their structures of production to match consumer demands (40).

Luckily for Japan, the increased money supply did not hit the economy and there was no great inflation, though not because of the so-called "liquidity trap." As Jeffrey Hebrener, economics professor at Grove City College argues in a 1999 Wall Street Journal Op-Ed piece,

the problem is not that interest rates are so low everyone expects them to rise and therefore hoards cash. Banks refuse to lend because of the overhang of bad debt. Any cash infusion is held as reserve against it. Businesses refuse to borrow because of their debt burden, built up to expand capacity during the boom, and their over-capacity resulting from their malinvestments.

Further,

Even if the Bank of Japan succeeds in reflating outside the banking system by purchasing debt directly from the market, it cannot counteract monetary deflation or credit contraction. Instead, reflation begins a separate stream of distorted prices and production that will some day need to be liquidated itself..(10).

Nonetheless, Japan attempted to overcome the liquidity trap by directly lending to private companies. This led to three results. First, when we factor this program in with other “off-budget” debts and the debts created from the other stimulus programs, Japan’s debt hit 200% of its GDP (Powell, 46). Second, while this system successfully bypassed the problem of banks not lending to businesses, since funds were now allocated based on the whims of the politicians, this led to a higher cost of borrowing of private funds, further distorting the economy (Powell, 46). Third, since the politicians directed the lending, they often gave money to favored companies, not companies that the people would have invested in. Indeed as the *Economist Intelligence Unit* notes, “FILP money is channeled toward traditional supporters of the LDP, such as those in the construction industry, and without proper consideration of the costs and benefits of specific projects” (EIU, 30).” For example, the government lent \$5.3 billion to a construction company to build a high-tech bridge-tunnel to span the Tokyo Bay, a project that the government acknowledged would suffer losses until 2038. The funding for shoddy projects further imperiled Japan’s finances (“The Rise and Fall of the Japanese Miracle”).

As to the host of other government undertakings related to propping up parts of the economy, these efforts were all misguided and further delayed the ability of the market to correct. Be it in buying up shares of companies whose stock values were

falling, trying to have an “orderly” unwind of real estate or giving projects or loaning to companies to bail them out, the fundamental problem with all of these policies is the same. Propping up failing ventures is incredibly harmful to the economy and only prolongs the inevitable and necessary correction. Allowing ventures to fail leads them to restructure so that they can come out profitable companies, or sell off their valuable assets to healthier companies. As Don Boudreaux, chairman of the George Mason University Economics department notes in a recent Wall Street Journal article on the American automakers,

A government bailout of the Big Three keeps huge amounts of productive inputs in firms that can't use them efficiently. Forcing taxpayers to subsidize the continued employment of gargantuan quantities of raw materials, labor and capital goods in unproductive pursuits is a recipe for economic stagnation. The popular and politically convenient myth has matters backwards: The bigger the unprofitable firm, the more vital it is that it be allowed to fail (“Bankruptcy Doesn’t Equal Death”).

In addition, were companies not allowed to fail, economies would never be able to advance. Certainly those involved with typewriter production or horse-drawn carriage building or operation were important at one time, but was the cost of propping up these industries greater than the benefit of the introduction of the computer or the automobile? Market forces need to be allowed to take over or a nation will suffer an unnecessarily long period of pain.

Ultimately, it is impossible to cover all of the bases of this issue in a short paper. Heretofore I have tried to enumerate the major causes of the boom, and the major reasons that the bust lasted so long. What I have not proposed is what should have been done to

prevent the great length of the bust. To this, I defer to Murray Rothbard, author of *America's Great Depression*. He notes that in a downturn

There is one thing the government can do positively, however: it can drastically *lower* its relative role in the economy slashing its own expenditures and taxes, particularly taxes that interfere with saving and investment. Reducing its tax-spending level will automatically shift the societal saving-investment/consumption ratio in favor of saving and investment, thus greatly lowering the time required for returning to a prosperous economy. Reducing taxes that bear most heavily on savings and investment will further lower social time-preferences. Furthermore, depression is a time of economic strain. Any reduction of taxes, or of any regulations interfering with the free-market will stimulate healthy economic activity; any increase in taxes or other intervention will depress the economy further.

In sum, the proper governmental policy in a depression is strict *laissez-faire*, including stringent budget-slashing and coupled perhaps with a positive encouragement for credit contraction” (22).

Rothbard provides the final piece to the Austrian critique of the boom and bust cycle. Japan did not heed these words, understandably as the Austrian prescription is not necessarily palatable to voters, and it paid a severe price. Surely Japan's woes were not solely about government intervention, but also major structural problems with Japan's financial institutions in their lack of transparency especially in terms of bad loans, taxes, rent control and zoning for farmland that discouraged property sales by keeping the price of properties high, protectionist trade policies and other regulations that delayed the correction (Wood, 163, 183, 210; Posen, 17). Nevertheless, I believe it has been amply documented that Japan's government intervened significantly to combat the recession, and that these efforts proved ineffectual and counterproductive in attempting to stop the liquidation that would have left the economy sounder. At this point it appears that

America is attempting these exact cures for its ailments. Let us hope that things turn out for the better here.

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