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PROGRAM ON ALTERNATIVE INVESTMENTS

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Lessons from the Japanese Bubble for the U.S.

November 19, 2008

Speakers

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Symposium Summary Report

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The Program on Alternative Investments at the Center on Japanese Economy and Business (CJEB) of Columbia Business School and Columbia University's Program for Economic Research and Weatherhead East Asian Institute cosponsored the symposium "Lessons from the Japanese Bubble for the U.S." Amidst a deepening U.S. financial crisis, 260 people attended to hear three specialists on the Japanese economy discuss what can be learned from the Japanese experience to help U.S. policymakers avoid a systemic crisis and the "lost decade" that Japan went through following the bursting of its asset bubble in the early 1990s. The speakers were Takeo Hoshi, Pacific Economic Cooperation Professor of International Economic Relations, University of California, San Diego; Paul Sheard, global chief economist and head of economic research, Nomura Securities International; and Michael Woodford, John Bates Clark Professor of Political Economy, Columbia University. Alicia Ogawa, director of the Program on Alternative Investments, CJEB, commenced the symposium with introductory remarks, and David Weinstein, associate director for research, CJEB, and Carl S. Shoup Professor of the Japanese Economy, Columbia University, served as moderator. This report is a summary of the speakers' presentations.

Professor Hoshi said crisis and change described Japan's financial system in the 1990s, and today those same words describe the U.S. financial system. Each country's financial crisis was preceded by similar run-ups in real estate prices and stock prices. Professor Hoshi pointed out that in Japan stock prices peaked and collapsed just before real estate prices, while in the United States the two happened almost simultaneously. Additionally, each country experienced the unexpected failure of one of their largest financial institutions—Yamaichi Securities in Japan and Lehman Brothers in the United States—which in both cases led to a spike in interbank loan rates.

A popular myth, Professor Hoshi explained, is that the Japanese government did nothing in response to the collapse of the asset price bubble and the financial crisis that followed. In fact, the recent approach of the U.S. government has resembled closely that of the Japanese government. Both countries started with a plan to purchase troubled assets and then shifted the focus to recapitalization. The key difference between the two governments' approaches, however, is the speed with which they first acted, and then adjusted their strategies. In Japan, the asset purchases began in 1993, and it was not until 1998 that the government began to recapitalize banks. The

United States made the shift from asset purchase to recapitalization in only five days. Professor Hoshi said the Japanese government's slow reaction to the crisis is something for which it has been rightly maligned.

Professor Hoshi then went into greater detail describing the Japanese government's recapitalization attempts, in order to identify lessons for the United States. In total, the Japanese government made five separate recapitalization attempts. The Financial Function Stabilization Act, which was a halfhearted first attempt at recapitalization that totaled about 1.8 trillion yen, was passed in 1998. The plan injected the same amount of capital into each bank, with the amount based on what the strongest bank requested, and it guaranteed all bank liabilities. This soon proved insufficient, and in 1999, under the Prompt Recapitalization Act, the government made by far its largest bank recapitalization attempt, injecting about 8.6 trillion yen. By 2006 there had been five recapitalization episodes. It is now clear, Professor Hoshi said, that these recapitalization attempts never were large enough to solve the capital shortage problems of Japanese banks in the long run. He then compared the 9 trillion yen figure with the cumulative losses that Japanese banks suffered from nonperforming loans. By 2005 cumulative losses totaled over 96 trillion yen, about 19 percent of GDP—clearly dwarfing the amount injected. Professor Hoshi said the question for the United States is whether the 250 billion USD that has been earmarked for recapitalization is large enough, given that no one knows the amount of troubled assets that still exist. Japan's experience suggests that small and repeated capital injections are, at best, only temporary fixes. Professor Hoshi added that one aspect in which the U.S. government has fared better than the Japanese government is in convincing financial institutions to accept public funds. In Japan, banks felt that selling the government preferred shares would suggest insolvency, thus stirring up concern among common shareholders. This has not been a problem in the United States.

In conclusion, Professor Hoshi identified two final lessons for U.S. recapitalization policy: the government must conduct due diligence of the financial institutions receiving public funds, and banks that receive public funds should not be forced to lend to small- and medium-sized firms. In Japan, many small but important regional banks were recapitalized, only to eventually fail. Additionally, because the goal of recapitalization is to enable banks to continue to extend credit, the Japanese government opted to require banks to lend to small- and medium-

sized firms. This policy kept credit open to many insolvent “zombie” firms, Professor Hoshi said, a fact that contributed to Japan’s subsequent decade of economic malaise.

Mr. Sheard built on Professor Hoshi’s presentation by clarifying some of the key differences between the Japanese and U.S. crises and described some further lessons. In Japan, the source of the crisis was a bubble in commercial real estate and equity market asset prices. Japan’s problem, therefore, was essentially nonperforming loans affecting the solvency of the commercial banking system. In the United States, the source of the crisis has been a housing market bubble involving subprime loans and mortgage-backed securities with very complex financial structures. Therefore, compared to Japan’s crisis, what is happening in the United States is much more of a market liquidity problem—as it also is in Europe and the United Kingdom. This has led to rising spreads across a range of products and caused serious dysfunction in large segments of the financial system. Mr. Sheard stressed that the reach of the U.S. crisis is much greater than it was in Japan. Whereas Japan’s crisis was very localized, the U.S. crisis has had global consequences, since bad assets were securitized and spread throughout the global financial system. Hence, it is a far more complex problem to address compared to the Japanese crisis, which was concentrated in about twenty financial institutions.

Mr. Sheard agreed with Professor Hoshi’s analysis of the Japanese government’s attempts to purchase bad assets and recapitalize the banks. He also noted that the Japanese government was right to recognize the danger of bank runs in 1995 and announce a blanket guarantee on bank deposits, which quelled the financial instability. These strategies, combined with unconventional monetary policy, constituted a comprehensive Japanese approach from which the United States can learn, Mr. Sheard said. But he added that the Japanese government acted far too slowly and timidly on all accounts. The policy of forbearance in response to the crisis contributed to Japan’s so-called “lost decade”—a mistake that should serve as a key lesson for the United States. For example, Japan did not guarantee bank deposits until 1995, even though by 1991 it was evident that real estate prices were plummeting. Furthermore, it was not until 1998 that the deposit guarantee was funded and an institutional infrastructure was implemented to deal with the troubled assets. The Japanese government’s reluctance to commit public funds and then to use them demonstrated a lack of political leadership, Mr. Sheard said. In a financial crisis, governments must trust the public’s intelligence and make a convincing case that injecting public funds and thereby increasing the budget deficit is the best strategy to minimize losses. Regarding monetary policy, Mr. Sheard argued that the Bank of Japan’s quantitative easing that began in 2001 was far too late and was conducted in a

somewhat self-defeating manner. Furthermore, the combination of timid monetary policy and counterproductive fiscal policy resulted in a macroeconomic strategy that failed to restore aggregate demand, defeat deflation, and return the Japanese economy to growth, he said.

Mr. Sheard next defined some general characteristics of financial crises and the monumental policy challenges they pose. Financial crises require remedial market intervention, which is very difficult to get right and runs contrary to the typical role of policy in a market economy. Additionally, policy makers operate under extreme uncertainty, and any action or inaction will be criticized. The more successful a policy is, the more it appears excessive *ex post*. Mr. Sheard was adamant that moral hazard arguments are dangerous when dealing with a financial crisis because they complicate the objective of the policy maker. This objective, he emphasized, should be to ensure that the economy returns to a high equilibrium path, no matter how valid moral hazard arguments seem at the micro level. Mr. Sheard said Japan’s policy of forbearance allowed the financial crisis to persist, and once the economy became deflationary, self-reinforcing feedbacks kept the economy on a low equilibrium path. He suggested that the United States is experiencing a slight but dangerous parallel with the severe distrust of counterparties and shortage of liquidity, which are causing the dysfunction of the capital market infrastructure. Even if the U.S. government deals effectively with the initial cause of the financial crisis—the housing market—there may be subsequent problems of sufficient magnitude to prevent the economy from getting back on a higher equilibrium path. Mr. Sheard ventured that the U.S. Treasury and Federal Reserve may have recognized this situation, saying this fact could explain their recent dramatic actions.

In closing, Mr. Sheard listed five general principles for dealing with a financial crisis based on the Japanese experience: (1) diagnose and take action early; (2) stem the financial crisis; (3) attack the underlying problem; (4) implement a coordinated and aggressive policy response; and (5) have a longer-term game plan that includes an exit and correction strategy. In his opinion the United States has done well in most of these respects, but it remains to be seen whether it has effectively attacked the underlying problem and will be able to successfully negotiate an exit and correction strategy. Through the Troubled Asset Relief Program (TARP) and other programs to prevent foreclosures, the U.S. government is trying to improve the asset value behind all the securities that are causing distress in the financial system. If the government backs off this strategy, it lessens its ability to address the underlying housing market problem, Mr. Sheard said. With respect to an exit strategy from the recent socialization, he said it must be sought as soon as possible and achieved through mechanisms

such as initial public offerings of government-acquired equity stakes. Finally, after there is adequate recovery from the financial crisis, a broad correction strategy is required to prevent the mistakes that led to the financial crisis and to address the moral hazard issues. Mr. Sheard suggested that this requires a breadth of new regulations, institutional rebuilding, and market learning.

Professor Woodford addressed the specific lessons that Japanese monetary policy in the post-bubble years holds for the United States today. Responding to the economic contraction in the early 1990s, the Bank of Japan (BOJ) began cutting the nominal call rate—roughly equivalent to the nominal federal funds rate in the United States—fairly aggressively, from over 8.0 percent in 1991 to 0.5 percent in the fall of 1995. By March 1999 the call rate was cut to zero, yet the consumer price index (CPI) inflation and GDP growth remained negative. The BOJ's dilemma was that the economy still needed demand stimulus, but the conventional tool of cutting the call rate had been exhausted, and the bank feared that monetary policy had become impotent. Professor Woodford said that the U.S. Federal Reserve was facing essentially the same problem, since—at the time of his presentation—the federal funds rate had been cut to 1 percent, meaning there was very little room left for further loosening, yet there appeared to be insufficient demand stimulus to avoid a serious recession and possibly even deflation.

In Japan's case, after much international pressure, the BOJ in 2001 resorted to an experimental quantitative easing (QE) policy, in which the BOJ's operating target become the current account balances of the banks, not the call rate, which remained at zero. The BOJ committed to continue this policy until deflation ended. By 2006, the BOJ had successively expanded the monetary base by 74 percent, yet nominal GDP had actually fallen slightly from 2001. To a large extent, the additional monetary base had been held as excess reserves by banks and the effect on aggregate demand was minimal, as evidenced by the relative stability of broader monetary aggregate measures like M2 and CDs. Professor Woodford explained this phenomenon by saying that, in theory, the effect of expanding the monetary base during ZIRP (zero interest rate policy) on aggregate demand depends on the extent to which expectations change regarding how long ZIRP will last or what monetary policy will look like after ZIRP. If QE is perceived as a very temporary solution that will be followed by rapid contractionary policy, there is no reason to expect an immediate positive effect on aggregate demand, he argued. In Japan, there was no indication of what would be done with monetary policy after ZIRP. Professor Woodford reasoned that expectations were that the BOJ would pursue very contractionary policy, and indeed, after ZIRP was abandoned in 2006,

the BOJ did exactly that. He said the QE policy in Japan was effective to the extent that it signaled that ZIRP would be maintained until deflation ended, causing longer-term interest rates to fall. One lesson from this for the United States is that signaling the conditions under which very low interest rate policy will be abandoned should be an effective tool on its own.

Professor Woodford went on to discuss in greater detail the importance of signaling the future path of interest rates, and he elucidated some further lessons that can be drawn from Japan's monetary policy. In April 1999, shortly after ZIRP began, the BOJ made its first direct attempt to signal future monetary policy. The BOJ realized that long-term interest rates were not falling, and popular expectation was that ZIRP would be abandoned quickly. Accordingly, BOJ governor Masaru Hayami announced that the bank was committed to ZIRP until deflation was no longer a concern. Professor Woodford noted that some people say this speech further lowered implied forward rates. However, he pointed out that there were also many contradictory signs suggesting the Bank was uncomfortable maintaining ZIRP. In August 2000, at the first indication of economic recovery, the BOJ raised the call rate 25 basis points. According to Professor Woodford, this small rate hike was more significant for the signal it sent about future monetary policy than its economic effect. The signal confirmed that the BOJ was eager to find a reason to raise rates. Term structure data from this time reveals that tightening was anticipated and likely caused the economic recovery to stall later in 2000, Professor Woodford said.

The BOJ's commitment to QE policy in 2001, which effectively signaled that it would maintain ZIRP until the year-on-year increase in CPI was positive, had a more robust positive effect than Governor Hayami's announcement in 1999, and eventually led to sustained mild economic recovery. Nevertheless, said Professor Woodford, there are important lessons for the Federal Reserve to learn with respect to why the QE policy was not more effective in creating aggregate demand. The BOJ signaled they would not raise the call rate from zero as long as deflation persisted, but it did not specify a plan for reflation. The first lesson is that the conditions under which accommodative policy will be terminated must include specific reflation targets to allay fears of continuing inflation. The second lesson pertains to the current expansion of the Federal Reserve's balance sheet. Professor Woodford said that when the BOJ pursued QE, the monetary base expansion was so dramatic that it was self-defeating because no one expected the BOJ to leave that amount of money in circulation. According to Professor Woodford, the Federal Reserve should signal that they are expanding the Central Bank's balance sheet consistent with their calculation of how much money should be in the economy after reflation is successful.

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