CHAPTER 1

Introduction

Abstract Since the mid-1980s, Japan, which was a leading competitor in the world's manufacturing sector, tried to transform itself to an economy with domestic demand-led mature growth. The ensuing bubbles, busts, and banking crisis, however, left the country chronicle deflation and stagnation. This book analyzes why the Japanese authorities could not avoid making choices that led to this outcome.

Keywords Financial cycle · Business cycle · Learning lessons · Greek tragedies · Déjà vu · Bubbles · Forbearance · Banking crisis · Clean-up

This report describes policy responses to the boom, bust, crisis, and recovery Japan experienced during the two decades from 1986 to 2004.

One hundred and fifty years ago, Japan started to westernize itself after the two centuries of isolation. Since then, it has made two miracles and two major mistakes.

The first miracle was the rapid modernization which within half a century turned the small agricultural island country in the eastern end of Asia into one of the five powers of the world. The miracle ended by the first tragic mistake of engaging in the Second World War. The US air raids in 1945 demolished the country.

The second miracle was its resurrection from ashes and the ensuing rapid economic growth. The country by 1968 became the second-largest economy in the world and dominated the world's manufacturing markets one by one; first textile, then steel, electronic appliances, automobiles, machine tools, and semiconductors. At the end of 1989, Japan was the world's largest creditor country. The eight largest banks in the world were all Japanese. The Tokyo Stock Exchange had the largest market capitalization and the Osaka the third largest. In 1995, the economic size of the archipelago reached 71% of that of the United States. Compare this with the relative size of the Chinese economy in 2018 to the US one: 66%.¹

This report is about the second tragic mistake which brought Japan from a leading economic power into an economy which struggled with persistent deflation and stagnation. It tries to explore where things went wrong, what were the alternatives, how and why the choices were made, and what would be needed to do better in the future.

FINANCIAL CYCLE AND BUSINESS CYCLE

The protagonist of the report is the financial cycle, or the financial boom-and-bust cycle. Figure 1.1 describes its stylized mechanism. In a market upturn, hikes in asset prices, increased collateral values, higher bank profits, reduced risk perception, and lax underwriting standards come hand in hand. These often result in over-investment, overspending and, eventually, build-up of unsustainable projects and overextended borrowers.

At the moment investors realize that the assets which looked like gems are in fact garbage—the Minsky moment, so dubbed in praise of Hyman Minsky's work in the 1970s—asset prices collapse, liquidity dries up, banks realize losses, capital constraints create a credit crunch, and the effects feed through to the real economy. Eventually, there is a reverse Minsky moment, when at the current market prices the assets once again look like good bargains.

The financial cycle tends to last longer than the business cycle. Borio (2014) argues that the business cycle typically ranges from 1 to 8 years, while the average length of the financial cycle has been around 16 years. That has indeed been the case in Japan, as Fig. 1.2 shows.

Fig. 1.1 A stylized mechanism of the financial cycle (*Source* Himino [2009] at [Risk.net](#))

Before the financial deregulation of the 1980s, advanced economies seldom encountered financial crises. At that time, economic policymakers in the advanced economies could largely forget about financial cycles and just focus on business cycles. After a decade in the job, they could acquire full knowledge of their trade through their own experience.

But since the financial deregulation of the 1980s, financial crises have become “an equal opportunity menace” for both advanced and emerging economies (Reinhart and Rogoff 2009). In order to witness all phases of a financial cycle, one needs to devote almost a full professional working life: For example, since I became a financial regulator 37 years ago, I have witnessed six-and-a-half business cycles in Japan, but only two-and-a-half financial cycles. One’s own experience therefore would not suffice. Those responsible for the financial stability or the macroeconomic policy need to learn from both other jurisdictions and history. Hence, the value of adding a concise overview of the Japanese case to policymakers’ library.

Panel A. Business cycles in Japan

Panel B. Financial cycles in Japan

Fig. 1.2 Business cycles and financial cycles in Japan (*Note* The unshaded areas indicate upturns and the shaded areas represent downturns. *Source* Cabinet Office, The Reference Dates of Business Cycle, and Index of Business Conditions; Bank of Japan, Flow of Funds Accounts Statistics; and Japan Real Estate Institute, Urban Land Price Index)

LEARNING FROM MISTAKES

When we try to learn from our own mistakes, we typically identify immediate and root causes and remove or mitigate them. If the mistakes are others', we identify why they went wrong and work to avoid doing the same. If that were enough, however, financial crises would not have been repeated so often.

We make many minor mistakes due to carelessness, stupidity, or greed. But, as classical Greek tragedies well portray, we make major mistakes because we are driven by forces bigger than us. Many people work with all their might and in good faith, but sometimes the combined effects of such efforts lead us to a tragedy. Only by understanding such mechanisms, can one avoid another tragedy.

Many of the English-language resources attribute what happened in Japan to incompetence or insincerity of policymakers, and perverse and outdated systems and practices unique to Japan. Those analyses helped the Japanese policymakers correct their deficiencies but may have nurtured a sense of complacency among non-Japanese people that similar crises would never happen outside of Japan.

Many incidents in the Global Financial Crisis in the 2000s, however, gave those who lived through the Japanese crisis a sense of *déjà vu*. The sudden market gridlock in the wake of the collapse of Lehman Brothers in 2008 resembled the interbank market freeze after the failure of the Sanyo Securities in 1997. Secretary Paulson's "Super SIV" proposal in 2007 was reminiscent of the Japanese Cooperative Credit Purchasing Corporation established in 1993. Depositors' long queues at Northern Rock branches in UK looked like what the Japanese saw across the country on November 26, 1997. The standoff over the Troubled Asset Relief Program at the US parliament in September 2008 revoked the memory of the debate over the bills on bank resolution at the Japanese Diet in August 1998.

To avoid repeating what Japan did, we need to know why it was hard for the Japanese policymakers at the time to make different choices.

FIVE PHASES IN THE JAPANESE FINANCIAL CYCLE OF 1986–2004

In the following chapters, policy responses to the Japanese financial cycle of 1986–2004 are described in five phases.

The first phase is the build-up of the asset price bubbles and corporate debts in 1986–1990. Chapter 2 will discuss how the fear of the trade war and the dream of a global city fueled the asset price booms. It will also discuss the relationship between the financial deregulation and the deterioration in the lending standards.

The second phase is the peaking of the bubbles between 1990 and 1991. As Galbraith (1954) said, “A bubble can easily be punctured. But to incise it with a needle so that it subsides gradually is a task of no small delicacy.” Did the Japanese authorities do too little and too late? Was the behavior of the US authorities in the 2000s any different? These are the questions I will try to answer in Chapter 3.

The third phase is the long intermission between 1990 and 1997. In most other cases, the periods between the asset price peaks and the systemic banking crises lasted only one to three years. But in Japan’s case, the intermission lasted as long as seven years. Chapter 4 will discuss whether the long intermission was the result of forbearance which exacerbated the problem or the inevitable result of lacking powers and funding to implement orderly resolutions.

The fourth phase is the systemic banking crisis in late 1997 and 1998. Crisis management requires considerations distinct from those needed in times of calm. Chapter 5 will discuss the tradeoff between preventing moral hazard and firefighting.

The fifth phase is the balance sheet adjustment of banks and borrowers between 1999 and 2004. The clean-up done during the period finally restored financial stability but at the same time made the whole Japanese economy more risk averse. Chapter 6 discusses this.

Chapter 7 reviews what Japan gained, kept, and lost during the two decades.

Books and articles written in Japanese and not translated in English are listed in the Reference section with the titles I have provisionally translated into English, together with the phonetic representation of the original Japanese title. Quotes from them are also translated by me. A Japanese name is expressed in the Japanese style (the family name followed by the given name, e.g., Ono Yoko), not in the Western style (Yoko Ono).

A Japanese fiscal year starts in April of the year and end in March in the next year. For example, FY 2020 refers to the period between April 2020 and March 2021.

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The views expressed are mine and are not meant to represent the views of the organizations I am affiliated with.

NOTE

1. World Bank, World Development Indicators database.

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