How was the performance of the Japanese Economy Before the Recession? (by Leung Yiu Pong)

Japan, an island country which inhabited by only 2.4 percent of the total population of the world. Nonetheless, Japan is regarded as the second largest economy of the world. She changed from an agricultural economy to an industrial economy. She has accumulated the largest mount of foreign exchange reserves in the world. She has played an economic miracle in the last century.

You may wonder how miraculous the Japanese economy is? The Japanese economy achieved a continuous prosperity with an average annual growth rate of 9.2 percent in the beginning 1950s. Then, the extremely outstanding economic performance of the Japanese economy was halted in the early 1970s. But she can also sustain a quite satisfactory economic growth at an average rate of 3.9 percent until the end of 1980s. And this growth rate has already been higher than the one of the other advanced countries by 1 to 2 percent. However, in the beginning of 1990s, Japan has fallen into a so long period of economic recession that nobody would imagine in advance.

Japanese Economy in the High Growth Period

The high growth period of Japanese economy between the early 1950s and the early 1970s was supported by a number of reasons, namely, influx of new technology, attractive investment environment, favourable terms of trade as well as relatively cheap labour. The enormous amount of new technology imported from the United States raising the productivity of Japanese economy remarkably. The new industrial technology transplanted from United States thrived the development of the electrical appliance, steel and automobile industry, such as Sony, Panasonic, Honda and Toyota, are regarded as the momentum of the growth of the Japanese economy. Apart from the technology, the cheap money policy of the Bank of Japan and the high savings rate of the Japanese also created a attractive investment environment that is essential for the growth of an economy. This is because the low interest rate and high savings rate lowered the cost money capital and provided the needed fund for investment respectively. Thus, the attractive investment environment prospered the Japanese economy. Besides, the favourable terms of trade also boosted the export of the visible trade of Japanese economy. The thriving export industries triggered off a large trade surplus of the Japanese economy in the high growth economic period. Last but not the least, the large amount of labour shifted from the primary sector to secondary and tertiary sector provided the necessary amount of relatively cheap labour for the Japanese corporations. The labour facilitated the development of the enterprises and hence generated the handsome profit. Thus, the Japanese economy also fueled by the
performance of profitable enterprises. However, the economic growth had cooled down in the early 1970s.

Japanese Economy in the Low Growth Period
The Japanese economy entered a low growth period from the early of 1970s and the end of 1980s. The economic growth has been lowered because of the stagnation of capital spending, worsening of terms of trade and stockpiling. The Japanese economy had overaccumulated the industrial capital in the high growth period. The overaccumulation of capital reduced the capital spending substantially. The sluggish capital spending stagnated the productivity of the Japanese corporation which acted as a resistance of the economic growth. Moreover, the price of raw materials and primary products had risen rapidly that affected the cost of production greatly. For instance, the price of crude oil had quadrupled from the late of 1973 to the beginning of the 1974. Hence, the terms of trade was worsened and depressed the export industries of Japan. Furthermore, the United States Federal Reserve abandoned the convertibility of the US dollar into the gold accelerated the global inflation. And the Bank of Japan kept the interest rate below the inflation rate and hence resulted in the negative real interest rate. Consequently, there were some speculative stockpiling of raw materials and the primary goods for production that crowded out some normal business activities and worsened the business environment. Thus, the economic growth of Japanese economy had been cooled down by the above factors.

In economic sense, it is inevitable that every economy would fall into the recession after the long term economic growth period. Needless to say, Japanese economy is the same as the above description and she stepped into the economic downturn in the beginning of 1990s. However, the extent and the duration of this recession is out of our prediction.
How did Japan Fall into the Recession?
Undoubtedly, the recent economic recession of Japan was triggered off by the bursting of the bubble economy. In Japan, the bubble economy was composed of a couple of part, the stock market and real estate market. The bursting of the bubble economy was not occurred simultaneously in these two markets. In fact, the bubble of the stock market bursted in 1990 first, then the bubble of the real estate market followed.

The collapse of the stock market
The inflated prices of share through speculative transactions in the stock market of Japan had risen far beyond the trend of real economic growth. The speculative transaction in the share market was originated by the gap in the rate of interest between United States and Japan.

The United States Federal Reserve Bank increases its interest rate gradually from 5.5 percent in 1986 to 7 percent in 1989. In contrast, the rate of interest was remained low in Japan in relative to the one of United States. In the middle of 1989, the interest rate of Japan was 2.5 percent. And the Bank of Japan raised the official interest rate three times to 4.25 percent in the end of 1989. As a result, there was a long period of different interest rate between United States and Japan. The relative low interest rate of Japan from 1986 to 1989 coincided with the crazy bearish stock market of Japan that the Nikkei Average of 225 shares in Tokyo Stock Exchange had risen from 13137 yen at the beginning of 1986 to 38915 yen at the end of 1989. The low interest rate triggered off the speculative transactions in the stock market of Japan. But the bearish stock market did not last forever, its collapse came to a halt at 1990.

Figure 1 The monthly trend of Nikkei Average 225 between 1981 to 2000

Source: Bank of Japan
The huge bubble in the stock market of Japan eventually bursted in the March 1990. The Nikkei Average 225 fell by about 10000 yen by March. But it is just the onset of the slump of the stock market in Japan. In the Figure 1, the curve shows that the Nikkei average 225 falls rapidly from the peak in 1990. And the falling trend is continue for a certain period of time. The Nikkei Average 225 continuously fell to around 15000 yen in the latter half of 1992. The total value of share listed in Tokyo Stock Exchange had disappeared for about 38 percent from its peak and that is equivalent to 430 trillion yen. There are a number of reasons induced to the disastrous slump of the stock market in Japan. First of all, the actions of Japanese banks contributed to the fall of stock market in a very large extent. This is because the banks wanted to realize their latent capital gain in the share market. Then the banks started to sell their equities in the stock market. Also, there were some banks sold their shares in order to cover in income loses on the equity portfolio. As a result, the selling of equities by the banks constituted a great outflow of capital in the overheated stock market in Japan. At the meantime, the insurance company and financial institutions in Japan also initiated their selling of the equities in the stock market. They sold their equities as they found that the bubble in the stock market was likely to burst. Hence, they lowered the ratio of the equities holding in the stock market of Japan in their portfolio in order to avoid substantial capital loss in this market. Their selling of equities also converted into a great downward pressure for the stock market in Japan. Furthermore, some of the small investors sold their equities and turned to invest in some short term high interest deposit. Thus, all of the above reponses of the investors created a great downward pressure and pessimistic sentiment in the stock market and hence induced to outflow of capital in the stock market of Japan. Eventually, a astonishing slump of the stock market in Japan occurred and which is so shocked that nobody had ever seen and predicted.

The collapse of the real estate market
There are few underlying causes for the skyrocketing land price in Japan, especially in Tokyo area. First of all, geographical factor had contributed to the high land price in Japan. The mountainous area accounts for three-fourths of the total area of Japan. The Japanese are concentrated in few major cities, such as Tokyo and Osaka. The demand for residential housing was high but the supply of available land was low. Therefore, the land price in Japan was high, especially in the Tokyo, Kanto and Osaka area. Moreover, Tokyo had been expanded as an international financial center. This phenomenon further boosted the demand for office space in this area. The international financial institutions set up their headquarters increasingly in 1980s. Likewise, more and more Japanese corporations moved their head offices into Tokyo
area. Thus, there was a high demand for office space of Tokyo in 1980s which contributed to the high land price in Japan. In addition, the tax on income from land sales is high in order to penalize the speculative investment. However, such tax policy limited the supply of the land in the market. This further stimulated the speculation of land in Japan. All of the above factors were also contributed to the skyrocketing land price of Japan.

The burst of the bubble of real estate market was not subsequent to the fall of share price. This is because many financial institutions maintained quite a lot of capital gain in stock market despite the recent collapse in share price. They obtained sufficient money funds through equity finance in the course of bubble. As a result, they needed not to sell the land or real estate immediately. And some of the developments of real estate were hard to withdraw in the course of construction. Thus, the fund was still flow to the projects of real estate and land market regardless of the fall in stock market. Besides, business firms and individuals believed in the myth if the tendency if land price to rise continuously. Therefore, they continued their speculative investment in either land or real estate market. They expected that the future gain from the speculation of land or real estate market could offset their substantial capital loss in the stock market. Thus, the continuous funds flow to the land and real estate market postponed the burst of the real estate bubble. But the myth of continuous growth in the land price came to the end in 1992.

**Figure 2** The land price index of six major land area in Japan

![Figure 2 The land price index of six major land area in Japan](image)

Source: Real Estate Institute of Japan

There were a number of factors contributed to the slump of the land price in Japan in 1992. In Figure 2, the overall price index begins to fall in 1992. And the fall of the commercial land price index is the most rapid one in relative to the industrial and
residential land price index. The investors or speculators found that was more and more difficult to sell their real estates because of the highly speculative price. And the breathtaking fall in the stock market affected the investment environment in Japan. Hence, the demand for office space, residential housing and vacant land decreased greatly. Above all, the Ministry of Finance advised the banks and financial institutions to regulate the total quantity of their loan to real estate because of the recent bank failures in the economy of United States. Thus, the corporations and individuals forced to reduce their business and speculations because they faced difficulties in borrowing funds from the banks. This depressed the demand of land substantially. As a result, the collapse of the land price of Japan was sparked off.
The Performance of Contemporary Japanese Economy During the Recession

The burst of the assets bubble brought Japanese economy into an extremely long period of economic recession. There were some phenomena worthy of discussing, namely, the non performing loan and banking crisis, zero interest rate, corporate failure and low consumer confidence. They will be discussed in the followings one by one.

The Non-Performing Loans and the Banking Crisis

The burst of the asset prices bubble in both of the stock market and real estate market created enormous amount of non-performing loans and hence affected the stability of banking system severely. In fact, the non-performing loans or questionable loan had been the major threat of the stability of the Japanese banking industry. In the March of 2000, the Financial Services Agency (a regulation agency of the Japanese banking industry) announced that the banks or financial institutions in Japan had 63.3 trillion yen problem loans, some analysts even thought that the true figure would be closed to 80 trillion yen.

The huge amount of non-performing loans were initially generated by the loans demanded by the real estate agencies, construction companies, speculators as well as the ordinary individuals during the bubble era. For instance, the total flow of loans into the real estate market at the end of 1991 reached 120 trillion yen. The collapse of the real estate market in 1992 triggered off the trend of bankruptcy among the above real estate market related companies, especially in the building sector that accounted for 42% of the total bankruptcy. Moreover, the economic turmoil in Japan also launched the layoff program in the Japanese corporations. The unemployed Japanese was unable to repay their housing mortgages. Therefore, the collapse of the real estate market generated a lot of non-performing loans that threatened the health and the stability of the banking industry in Japan.
Furthermore, the Basel Agreement of the Bank of International Settlement in 1988 regulated the Japanese banks to keep the ratio of own capital against total assets above 8 percent that was effective from the April of 1993. Thus, the non-performing loans not only affected the health and stability of the banking industries of Japan, but also impeded the recovery of the Japanese economy. This is because the Japanese banks need to restrain loans at this critical moment in order to maintain certain amount of capital and hence satisfied the Basel Agreement. As the asset value of the stock in the portfolio of the Japanese bank diminished continuously, they were restricted by Basel Agreement and hence not allowed to loan to the corporations. Consequently, the recovery of Japanese economy was somewhat dragged down because some of the Japanese corporations cannot obtain needed money capital from the banks.

In fact, the Japanese government had launched a 70 trillion yen rescue package for the banks to ease their difficulties brought by the non-performing loans. It was merely avoided an outbreak of the banking failure, but it cannot turn the Japanese banks into a financially sound condition. This is because the non-performing loans grow persistently, it almost increases at a rate as fast as the banks can write off them. For instance, according to the Bank of Japan, the Japanese banks had written off 6 trillion yen of bad loan from the January to march of 2000 meanwhile the another sum of 5.6 trillion yen appeared in the same time. Therefore, the prospect of the banking industry is still dim because it is hard to get rid of the non-performing loans in the Japanese economy, even there is another rescue package.

The Low Interest Rate Policy
The interest rate of the Japanese economy is continuously low aftermath the burst of the assets bubble. The interest rate has fallen from 6 percent to 0.5 percent between the beginning of 1991 to the end of 1995. And this trend is kept up until now.

There were a number of reasons supported for the low interest rate policy in the Japanese economy. First, the higher interest rate would lead to a stronger yen. The stronger yen would higher the export price and lower the import price. Consequently, it would affect the exporting industry as the export price is higher. This would inevitably depress the economic growth of Japan. Moreover, the lower import price would intensify the deflationary force. This phenomenon would also deteriorate the health of the economy. Thus, the Bank of Japan kept a low interest rate.

Secondly, the low interest rate could stimulate the investment and hence accelerate the economic growth in Japan. This is because the corporations can borrow the money
capital with lower interest expenses. When the cost of borrowings is lowered, the Japanese corporations would be more willing to borrow and invest. Therefore, the low interest rate created an attractive investment environment for the Japanese corporations. Apart from the view of investment, the low interest rate also encouraged the consumption of general public instead of saving. The low interest rate implies that the returns on savings is low, and hence tempts them to consume. The higher consumption by the general public could also improve the health of the Japanese economy. In short, the low interest rate in Japanese economy can boost the investment by the corporations and consumption by the general public. Hence, the low interest rate can fuel the economic growth in Japan.

Last but not the least, the Japanese economy maintain a low interest rate because it can avoid the Japanese bank to face more problems and hence maintain the stability of the banking system of Japan. As a matter of fact that value of bond is varied negatively with the interest rate. This means the higher was the interest rate, the lower was the value of bond, and vice versa. However, the Japanese banks had been the enthusiastic buyers of the government bond after the burst of the bubble in the equity market. The higher interest rate would lower the value of the bond. Thus, the asset value of the banks would be lowered consequently. As some of them had already been undercapitalized, so they are vulnerable to the higher interest rate. On the other hand, the low interest rate could also relieve the financial stress of all Japanese corporations by means of lowering the interest expenses. If the interest rate is high, the interest expenses may increase the financial burden of some corporations. It may be fatal for some not very profitable corporations. And hence changed their debt into the nonperforming loan. This would further exacerbate the stability of the Japanese banks. Then there would be lesser hope for the recovery of the Japanese economy.

**Corporate Failures and Bankruptcies**

The economic gloom in Japan deteriorated the business environment that triggered off either the business failures or bankruptcies of many sickly firms. The underlying reasons for their failures are almost as same as the causes of the economic turmoil of Japan. Most of them suffered substantial losses from the depressed real estate and equity market. And the weakened consumer demand also exacerbated their business environment. Eventually, the sickly corporates declared bankruptcies, for example, Chiyoda Mutual and Sogo.

Chiyoda Mutual was the twelfth largest life insurer in Japan. This business failures is the biggest bankruptcy in the history of Japan. Chiyoda Mutual left behind 2.9 trillion
yen of debt. And its liabilities exceeded its assets by 34.3 billion yen. Apart from its losses from the properties and stocks market, Chiyoda Mutual also engaged in the bank-style lending business for other firms, however, the long term economic recession turned much of the loan to sour. Moreover, as its investment returns failed to match the guaranteed payouts on its policies, rumour of its trouble had prompted many customer to cancel their policies. Thus, the Chiyoda Mutual was lost at least 40 billion yen a year. Hence, the bankruptcy of Chiyoda Mutual occurred.

Sogo was another example of the bankruptcy of the Japanese corporations. When Sogo collapsed, its liabilities was reaching 2 trillion yen. Obviously, the failure of Sogo was due mainly to the sluggish consumer demand. The stagnant consumption reduced its turnover year by year. It directly cut off great amount of source of income of Sogo. In addition, the entry of the new competitors made the competition in retailing market to be more severe. And the price deflation also restricted profitability of Sogo. Therefore, Sogo declared its bankruptcy in July 2000.

The business failures of Chiyoda Mutual and Sogo are just two of examples of the bankruptcy in Japan. In fact, there were more and more firms or enterprises went bust in Japan. The number of bankruptcies grew 23.4% over the previous year to 19,071 cases in 2000, up from 15,460 in 1999, showing the first year-on-year rise in two years to top 19,000. This figures further shows how gloomy is the Japanese economy.

**Stagnant internal consumer demand**

Apart from the banking crisis, low interest rate policy and corporate failures, stagnant internal consumer demand is the forth economic phenomena of the contemporary Japanese economy. According to the International Financial Statistics Yearbook, the annual percentage change of the household consumption expenditure in Japan had fallen from 2.31% in 1996 to –0.61% in 2000 regardless of the increase of 0.55% in 1999. The depressed consumer expenditure acted as the hindrance of the growth or recovery of the Japanese economy.

The burst of the asset bubble affected the consumption behavior of Japanese greatly. The fall in assets deflation in 1990s created negative wealth effect for the economy. As the value of the asset had deflated continuously after the burst of the bubble, the value of asset for both of the stock and real estate evaporated for more than a half in relative to their peaks. People tended or inclined to less willing to consume. When one decreased his or her consumption, the disposable income of others would decrease in result and so on. Consequently, the less lucrative consumption behavior rolled over
and hence created a negative wealth effect. And it eventually constituted to the stagnant consumer demand in the recent Japanese economy.

Either the gloomy performance or prospect of the contemporary Japanese economy affected the consumer confidence of the Japanese. The consumer confidence of the Japanese has continually diminished. This is because the spread of economic downturn leaded to the increasing bankruptcies, layoffs, downsizing or restructuring of the enterprises as well as cuts in overtime and bonus. All of the above factors affected the consumer confidence due to the likelihood of being fired or reduced income. The Japanese would prefer saving rather than consuming because they can have certain amount of savings in case of being laid off. As a result, the consumption expenditure of the Japanese economy further depressed. In addition, the government policies also weakened the consumer expenditure as the Japanese government neglected how important is the consumer demand in process of economic recovery. In the fiscal year of 1997, the Japanese government raised the consumer tax, individual payment of medical services and abolition of the special allowance on income tax. These expenditures acted as a number of additional burdens of the consumers and hence lowered their disposable income. Needless to say, the internal consumer demand unavoidably depressed by the policies of Japanese government.

In short, it is hard to distinguish the nature of the stagnation consumer demand. The stagnant consumer demand is both of the unavoidable result and cause of the economic downturn of Japan.

Prospect of the Japanese Economy
As a conclusion, it is hard to determine when and how will the Japanese economy step into the recovery. But the evidences show that there still has a long road for the goal of recovery. Nowadays, there is no doubt that the economic recession is occurred globally. The 911 effect and its consequences further proved that the United States is also slipped into recession. This would further affect the exporting industries in Japan as United States is her largest importing country. Moreover, there are a lot of socio-economic problems in Japan, for example, high unemployment rate, falling population and high bankruptcy rate, while the Japanese government has already been exhausted and puzzled by the problem of unperforming loan. All in all, it is inevitably to has a pessimistic view on the future of the Japanese economy.
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