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## Event Report

# Program on Alternative Investments of the Center on Japanese Economy and Business Panel: “Lessons from the Japanese Bubble for the U.S.”

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*The Japanese response to the asset bubble of the 1990s is an oft-cited comparison in trying to understand how the United States should react to its current financial crisis. Although the Japanese policy response is frequently referenced, many people fail to grasp the intricacies of its successes and failures. At “Lessons from the Japanese Bubble for the U.S.,” sponsored by the Program on Alternative Investments of the Center on Japanese Economy and Business, Columbia Business School, three leading experts on the Japanese crisis brought their different perspectives to the audience at Columbia Business School on November 19, 2008. With a local, an outsider and a market view, the panelists helped the attendees grasp the core concepts of the policy response and what can be done by the United States to learn from both the successes and the failures in dealing with what may be the financial-market downturn most similar to our current state.*

Takeo Hoshi, Pacific Economic Cooperation Professor in international economic relations at the School of International Relations and Pacific Studies at University of California, San Diego, and coeditor\* of the book *Crisis and Change in the Japanese Banking System* (Springer, 2000), discussed the similarities between the crises and his thoughts on the lessons we can learn from Japan. To start his presentation, Professor Hoshi showed a series of captivating graphs that

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\* With Hugh Patrick, the Robert D. Calkins Professor Emeritus of International Business and director of the Center on Japanese Economy and Business, Columbia Business School.

implied that the United States may be only about one-third of the way through its real estate devaluation. Next, attention was turned to dispelling the myth that Japan did nothing to respond to the bubble and ensuing market crisis. Actually, the Japanese policy response was similar to the initial U.S. reaction in so far as the government both bought assets and injected capital into the ailing system. However, the key difference is that while it took Japanese policymakers five years to react, the United States assembled the same response in just five days.

The similarities of the crises focus on bank failures, a spike in interbank borrowing, new accounting and a half-hearted recapitalization plan. To highlight just how devastating the crisis was to the Japanese economy, Professor Hoshi pointed out that by 2005 the cumulative loan losses reached a staggering 19 percent of GDP, for a total of ¥90 trillion. This occurred despite five attempted recapitalizations, the largest of which was ¥8 trillion in 1999. This raises the critical question whether the U.S. stimulus response so far is enough.

Professor Hoshi pointed to four key lessons that the United States can learn from the Japanese recapitalizations. First, the reluctance of private banks to receive funds signals to market participants that the banks are insolvent, further exacerbating the market effects of the crisis. This lesson should lead those making the recapitalizations to ensure that the funds are injected universally (with all market participants), rather than further spotlighting the institutions with the greatest problems. Second, small and temporary recapitalizations ease the capital shortage only in the short term. The stimulus should therefore be as large as possible and executed in the shortest possible time. Third, recapitalizing banks whose underlying business is failing is counterproductive. Zombie banks in Japan—those that were losing money and only surviving because of the capitalizations—placed further strain on the financial system. Thus, unhealthy banks should have a clear and accelerated process for either restructuring or liquidating in an orderly manner. Lastly, a recapitalization with the requirement to increase lending to small and midsize firms may have been counterproductive. So, banks should continue to have control over their lending standards, as government-imposed restrictions and requirements may perpetuate the poor functioning of credit markets.

As former chief global economist for Lehman Brothers, Paul Sheard continued the lecture with a more practical but no less informed perspective on the Japanese crisis. Mr. Sheard focused his presentation on three key issues: What Japan did right, what Japan did wrong and what financial crises are like.

According to Mr. Sheard, Japan did four things correctly. First, it quelled instability by offering a blanket guarantee of bank deposits. Next, policymakers bought up troubled assets

(nonperforming loans) to remove them from the balance sheet of the financial institutions. Then Japan focused on recapitalizing the banks with healthy assets. Most important, the Japanese response consisted of using unconventional monetary policy, such as 0 percent interest rates and quantitative easing, to help get the markets functioning again.

Quantitative easing is the process by which the central bank increases the monetary base to a level beyond what is required to keep the call rate at 0 percent by targeting current-account-balance raises. In Japan, this process led the monetary base to increase by 60 percent from the early 1990s to 2005.

While Japan had its correct responses, it also had four significant failures that led to the continuation of the negative market response. First, the government delayed its response by relying on forbearance, as its 5-year plan quickly turned into a 10-year plan. The second failure of the Japanese response was the extreme reluctance to commit and use public funds. This led to the next misstep, as the government made a timid monetary-policy response and pursued a counterproductive monetary-policy response that was neither coordinated nor aggressive. The grand takeaway from these responses was that public money is money well spent if leaders coherently explain the monetary policy.

Mr. Sheard also offered his view on “What financial crises are like,” or, more aptly, what pitfalls leaders currently must navigate in order to respond well to this type of unforeseen cataclysmic event. First, monumental policy changes must be presented. Remedial market interventions go against the grain because one simply cannot respond to abnormal events in a predictable manner to achieve results. Second, it is important to remember that U.S. leaders are operating under extreme uncertainty that lends itself to a no-win situation. If the initial policy is successful, then policymakers run the risk of being chastised for excessive policy, yet too little response may accelerate or extend the crisis longer than necessary. Also, moral-hazard arguments tend to get in the way of effective policy response, when in reality, Mr. Sheard said, one should “put the fire out first, and then figure out how to rebuild the house to prevent a reoccurrence.”

Mr. Sheard offered the audience some general principles for reacting to financial crises. First, they should be diagnosed and acted upon sooner rather than later. The prime goal should be to stem the financial crisis and attack the underlying problem. To achieve success, a coordinated and aggressive—that is to say, unconventional—policy response is necessary. This policy should, most important, be effectively communicated with a long-term plan, including an exit and correction strategy.

Taking a more traditional academic macroeconomics approach, Michael Woodford, the John Bates Clark Professor of Political Economy at Columbia University, presented on the topic

of “Monetary Policy at the Zero Bound.” In response to the Japanese crisis, the call rate (Japan’s version of the U.S. federal funds rate) was slashed from 8 percent in 1991 to 2 percent in 1995, with further cuts to 0.5 percent in the fall of 1995 and finally to 0 percent in February 1999. However, despite these dramatic moves, Japan still experienced significant deflation and weak economic growth. This led to the question whether monetary policy is effective in responding to a financial crisis, a critical question for the United States today.

But was quantitative easing effective? There was no increase in nominal aggregate demand over the period simply because of the larger monetary base. Even by March 2006, there was still slight decline in nominal GDP, despite the asset base growing by 74 percent. This was primarily because the additional funds were held as excess reserves over the period. A theoretical analysis indicates that quantitative easing should have no effect if it doesn’t change the expectation or duration of the 0 percent interest rate policy. A helicopter drop of money should affect aggregate demand only to the extent that the money is expected to remain in circulation.

In 2002, Chairman Ben Bernanke of the Federal Reserve questioned why anyone would expect this money to be withdrawn at a later date. However, this is precisely what happened in Japan. Some would argue that the quantitative-easing policy was effective; however, there is much evidence to prove that the effects were simply a consequence of changed duration expectations. The most important aspect of the policy was its effect on policy signaling. Quantitative easing assures that the 0 percent interest rate policy will end, but there needs to be a clear commitment to reflation at some point in the future. In conclusion, Professor Woodford reiterated that policy signaling could be a valuable tool but that appropriate end commitments are just as important.

With a better understanding of the successes and failures of the Japanese policy response to its financial crisis just a decade ago, market participants are better able to view the validity of their policy responses with greater perspective. The key themes of the policy response to a financial crisis should be to act with great haste, magnitude and clarity. These three critical factors should remain at the forefront of policymakers’ thinking about responses to financial crises. In this way, they can be better informed as to whether the United States will experience its own lost decade or has learned from ghosts of crises past.

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