The Linkage of Land Price with the Economy

Policy Making Failures of the Japanese Government in the 1990s

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Introduction

The Japanese economic policy experience in the 1990s was the worst observed in the country for many decades. The government withheld critically important economic information from the public, such as the size of non-performing loans held by financial institutions, while policy-makers were waiting in vain for the economy to revive. Certainly there was no leadership in the political arena that would give direction to the bureaucratic decision making process. Senior ministerial staff continued to make serious mistakes that were implicitly supported by politicians through their own non-action.[1] The authors share the view with Posen (1998) that the major economic problems of Japan during the 1990s arose due to policy-making mistakes within the country. Once lauded for their wise judgement, Japanese bureaucrats are now viewed by many as having been motivated mainly by their own interests and by costly face-saving measures.

As a consequence, the economy that was an envied model of economic development at the end of the 1980s has become one of the most sluggish economies within the industrialized world. Instead of being accused for its aggressive export led growth strategies, as was done in the previous decade, Japan has been prodded to act more boldly by other industrilized countries. Now, after the financial and economic meltdown in East Asian economies starting in the second half of 1997, some writers are accusing Japan of contributing to the crisis by virtue of its own stagnation.[2]

Behind the monumental malperformance of the Japanese economy lies the political-economic structure, established during the war years in the early 1940s, and enhanced during the Occupation period of 1945 through 1952. The system worked superbly while the country was in the process of catching up with the advanced economies, but is now miserably outdated and obsolete in a more globalized world.[3] Policy makers in Japan are not held accountable for their actions. They often conceal critical information, and may wait for problems to disappear rather than action. In the case of the financial and economic

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[1] They include optimistic and self-serving economic forecasts from 1991 on, the rescinding of temporary tax cuts and the increase of the rate of the consumption tax of 1997. Their overall hike of land-related taxes of 1990 and other measures for depressing land price may also be called mistakes. See, for example, Mihara and Miyao(1992), Miyao and Tobioka(1993), Ohmae(1994),Sataka(1996),Shiota(1993), and Mera(1998).

[2] For example, Henderson(1998).

[3] Excellent analysis is provided in Van Wolferen(1989) and Johnson(1992).

problems arising in the 1990s, they have not disappeared, and the cost of non-action has been enormous indeed. It has led the entire region to the brink of severe depression.

The Prelude to the Problem: the Booming 1980s Economy

Japanese economic policy-makers gained confidence after overcoming the second oil-shock of 1980. The economy was growing at a healthy rate of four to five percent, and the trade surplus was also growing. The Japanese business management style was gaining a global reputation for efficiency. Just-in-time delivery method and total quality control were introduced to other industri!alized countries. Meanwhile, the United States economy was in disarray. The U. S. government requested Japanese auto makers to limit their exports to the U. S. voluntarily until American auto makers could become competitive. Seemingly overnight, the United States became the world's largest debtor nation, while Japan became the world's greatest creditor. Multilateral negotiations at that time led to the Plaza Accord of 1985, in which central bankers and financial ministers of the industrial countries agreed to realign currency exchange rates so that U. S. exports would increase. Within a year or so, the Japanese currency's value doubled vis-a-vis the U. S. dollar, as did the German mark.

Another factor that had significant impact on the Japanese economy was financial deregulation. The Ministry of Finance had strong control over all traditional financial institutions in Japan. All interest rates were guided. However, due to pressure for deregulation from other countries, the ministry started liberalizing its regulation of financial institutions in the mid-1980s. In addition, major corporations found alternative ways of raising money other than borrowing from banks. Banks began competing with each other by providing increasingly attractive interest rates, and by cultivating new customers such as small and medium corporations. Such price-competition was a totally new experience for Japanese bankers. It was in this context that property development became an attractive target for lending.

As a part of the financial deregulation program, the Tokyo Stock Exchange membership was opened to foreign corporations. Seeing a robust economy and a large pool of savings by Japanese households, many foreign financial institutions applied for membership. Due to a general expectation of continued economic growth and currency appreciation, the capitalization of firms listed in the Tokyo Stock Exchange rose dramatically. All major global financial institutions set up offices in Tokyo, depressing the vacancy rate of downtown office space. As office rents rose in the central Tokyo, so did land prices.

Land ownership in Japanese cities traditionally is extremely fragmented. Thus, to produce a high-rise office space many adjoining parcels of land must be purchased. However, the original land owners were generally reluctant to sell, because selling the land under one's own residence or business establishment is interpreted by many Japanese as a signal that the owner' fortunes are in decline. To purchase land, therefore, developers, usually acting through intermediaries, had to offer very high prices to overcome this resistance. As land consolidation proceeded along with rising land prices, many sellers relocated to more peripheral locations with substantial cash equity. As a result, for example, a small tofu- maker might became an instant multimillionaire. Then, those millionaires, in turn, bid up land prices in the most preferred residential areas. Thus, land prices commenced their rise in the central business districts of Tokyo first, and then spread to other business areas as well as residential areas in the Tokyo metropolitan area. Land prices in Osaka and other major cities lagged by two years. During 1985 alone, the commercial land price in the central three wards of Tokyo rose by 54 percent.[4]

The competition among banks with large volumes of liquidity also fuelled land prices. To fight against the deflationary impact of the appreciated yen, the government undertook to promote domestic demand in accordance with the Maekawa Report, produced at the request of Prime Minister Nakasone. The Black Monday of October 1987 at the New York Stock Exchange further enhanced this spiral. To aid in the recovery of the equity market in the United States, the Bank of Japan lowered its official discount rate to an historical low of 2.5 percent. These forces reinforced the rising trend of land prices in Japan.

The confidence of business people in Japan further encouraged investment in land. During the entire post-war history of Japan, the price of land never fell, except for once immediately after the first oil shock of 1973. But, the decline at that time was mild. The value of land kept rising consistently. In the late 1980s banks were willing to lend more than the value of land because it was thought that the value would soon increase significantly. Due to competition and the upward spiral of asset prices, banks' lending practice had lost due diligence. The Ministry of Finance was actively supporting those banks rather than supervising them rigorously. In addition, many banks were channelling funds to the real estate sector through non-bank financial institutions, because they were outside the purview of control by the Ministry of Finance. In addition, the financial liberalization that was being promoted was taken by many to be an absolute reduction in governmental intervention.

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[4] Land Agency (1990), p. 82.

Japanese corporations also invested heavily in properties abroad during this period. As prices overseas looked so affordable in terms of Japanese yen, particularly after the Plaza Agreement, many trophy properties were purchased in the United States and Europe during the late 1980s. This flow of investment funds created a global property price inflation.[5] In particular, property price increases in London, New York, Los Angeles, and Hawaii during the late 1980s are attributable in large measure to Japanese direct investment in these sectors.

As a result of these multiplicity of factors, the price of commercial land in Tokyo rose three and a half times during the period 1983 to 1989, while the price of residential land increased by a factor of about three times during the same period. In Osaka, the price rise was delayed, but the intensity of the price rise was sharper. In smaller cities, the degree of increase was much smaller. In Tokyo, the price reached a peak in 1987 and then declined slightly only to hit another peak in 1989.[6] The economic power of Japan had reached its zenith at that time.

The Downfall of Land Prices and the Economy

While some argued that land prices were rising excessively, many corporations and investors sought to benefit from the pervasive land price escalation. Particularly attractive for developers and their financiers were luxurious office buildings, high-end condominiums and resort facilities. Large sums of money were lent for such developments.

During this period the government became increasingly concerned with the steep rise in land prices. Many councils and commissions were formed by various ministries and by the cabinet on this issue. On the whole, they raised three main points of concern: (1) the increase in land values was creating wide disparities in wealth holdings between those who owned land and those who did not, (2) housing was becoming beyond the economic reach of ordinary households, and (3) earned income was becoming insignificant relative to unearned income, possibly reducing the ordinary workers' incentive to work.[7]

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[5] Renaud(1997).

[6] Land Agency(1990).

[7] Many committees and councils were formed by the government, including Cabinet Council for Land Price Policy(December 1986), the establishment of Land Policy Committee within the Temporary Deliberation Council for Administrative Reform(July 1987), Cabinet approval of the Principles for the Emergency Land Policy(October

Interestingly, these lines of inquiry did not question the efficiency of the market, but instead questioned possible implications for market allocation of resources. The popular media reported extreme cases of land price increases, often attributing it these increases to *yakuza* (organized crime syndicates) and to speculators. The Land Agency was the first one to take action. It examined various causes of the rise in land prices, but did not come out with strong measures. [8] What emerged from various public debates on this issue were two contrary views:

1. The increase in land prices is a natural and inevitable outcome of rational market resource allocations. To reduce the land price, the supply of effective usable land to the market should be increased through such measures as relaxing requisite floor-area ratios, abolishing controlled urbanization zones, and substantial deregulation of land use and building codes;[9]

2. The market cannot allocate land in a satisfactory way. The government must regulate the market directly and indirectly so that a satisfactory outcome can be derived. The price of a housing unit should not exceed 5 times the annual income of an ordinary household, and the price of land should be reduced to achieve this target. The price of land at that time was excessive, and therefore, its reduction should not affect the economy adversely.[10]

The government, led by the Ministry of Finance, took the second view and undertook the following measures:[11]

- *Direct control of land transaction price from 1987* -- Within designated areas in which land price rose significantly, parties prepared to transfer ownership of land were requested to report the intended price to the local government for approval.

1987) and the Comprehensive Land Policy Principles(June 1988). In December 1988, the Basic Law for Land was enacted. See Chika Mondai Kenkyukai(1987) and Mera(1992).

[8] The Committee for Examining Land Price Issues was formed by the Land Agency in February 1986 and completed a report in March 1986, and the Land Price Policy Council was established also by the Land Agency in September 1986, and completed a report in December of the same year.

[9] This position was represented by the Land Agencys earlier committees.

[10] This position was represented by the Government Taxation Examination Council of 1990.

[11] Refer to Mera(1992) and Mera(1998).

- *Interest rate hike by the Bank of Japan* -- The Bank of Japan raised its official discount rate in May1989 from 2.5 percent to 3.25 percent. Within a span of 15 months, it raised it to 6 percent. This was a significant and drastic increase not expected by the private sector.
- *Direct control on property-related lending* -- The Ministry of Finance issued a directive to banks not to increase the share of property-related lending. This directive was effective from April 1990 through December 1991.
- *Land taxation reform* -- The Government Deliberation Council on Taxation started to examine land-related taxation in April 1990, and concluded in November that all land-related taxes should be significantly strengthened. As a consequence, a new national tax on land value was established effective in 1992, and property tax, capital gains tax, and inheritance tax were all strengthened as of April 1991.

These measures had considerable impact on land prices through several channels. First, direct controls on land prices reduced land ownership transactions as the government judged the proposed transaction price to be excessively high. Second, high interest rates impacted negatively on borrowers' demand for debt financing. Contrary to their previous expectations, the expected return to borrowers from property investments was drastically reduced or wiped out altogether. This reduced the attractiveness of land ownership. Those who had started projects were obliged to borrow additional funds even though the interest rate was unexpectedly high. Many property development plans were scaled back, postponed, or abandoned. Third, the control on property-related lending hit hard some of the firms that had ongoing projects. Combined with the rise in interest rates, they had either to cancel or postpone their projects. In either case, those real estate companies and other companies involved in property-holding or development experienced unexpected financial damage. Fourth, the strengthening of land-related taxes directly and negatively impacted on land prices. Any increase in tax on land directly reduces the yield from land and thus reduces the price of land. With regard to the land-holding tax alone, the tax rate for commercial land increased from a mere 0.1 or 0.2 percent before the tax reform to 1.3 percent when the planned tax increases were fully achieved.[12] The immediate and cumulative impact made itself apparent during 1991. Residential land prices fell 16 percent in central Tokyo and 19 percent in central Osaka. There was a similar rate of reduction in land prices during 1992 in Tokyo and Osaka, when the fall in land prices was

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[12] This increase will be due to two factors: raising of the assessment rate from a small fraction to 70% of the market price, and an addition of the newly introduced Land Value Tax with a tax rate of 0.3%.

observed in most other prefectures as well.[13] This falling trend continues as of 1999. By early 1998 the overall price of commercial land in the three large metropolitan areas had fallen 35 percent off their peak values, with a comparable figure of 61 percent for residential land.[14]

As the decline in land prices was global during this period, some analysts attribute it to the fall of Berlin walls of 1989, the Persian Gulf Crisis in the summer of 1990, or the German unification in 1991.[15] However, it seems obvious that the package of measures enacted by the government of Japan from 1989 to 1990 was decidedly instrumental in sparking the fall of land prices within Japan by 1991. Certainly, based on the theory of land value as the present value of the future income stream derived from the land, an increase in interest rates or in tax rates on land should reduce the price of land. The stock market index in Tokyo began its decline at the beginning of 1990. This is readily attributable to the steep hike in the official discount rate made by the Governor of the Bank of Japan on December 25, 1989. Land prices started losing value in Japan just as the Deliberation Council on Taxation determined in the fall of 1990 that all land-related taxes should be drastically strengthened.

The Land Price-Economy Linkage

Damage arising from the fall in land prices in Japan would have been less extensive if that fall had not been accompanied by a more general economic stagnation. In fact, the government kept insisting that falling land prices would not affect the economy adversely. As late as 1991 and 1992, the government's *White Paper on the Economy* presented regression results purporting to bolster this assertion of theirs.[16] However, clear signs of economic distress were observed within the macro economy as soon as land prices began falling. The GDP growth rate dropped from 3.3 percent for 1991 to 0.4 percent for 1992. Since then, with the exception of 1995 and 1996, it has been consistently close to zero or negative as shown in Table 1. The consumption propensity of ordinary households has been consistently declining from 1990, during which time private investment has also declined. Moreover, companies' productive capacity utilization rate has declined by more than 10 percent from its peak in 1990. Meanwhile, the unemployment has been rising steadily since 1990, and by the end of 1998 it was 4.4%. To counter this trend, the government announced eight distinct economic stimulus packages totalling 99.3 trillion yen

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[13] Refer to Land Agency (1993).

[14] Refer to Land Agency(1998).

[15] Miyazaki (1992), 202, Takao (1994), 165-168, Miyao (1995), 21-24, and Renaud (1997).

[16] This is presented in Economic Planning Agency(1991) and (1992).

from 1992 to 1998 (see table 2). Despite this enormous stimulus, the economy scarcely grew at all during this period and has been contracting since 1997 (see table 3). The economy continues to be in distress, despite repeated government assurances to the contrary.

The government position towards economic policy is clearly presented in its annual *White Paper of the Economy* published by the Economic Planning Agency. In 1992, it said the economy was in the process of adjustment and the fall of asset prices, though they might have some adverse impact on investment, would not change the basic economic trend. In the meantime, the Ministry of Finance was trying to save banks from bad loans by making funds available to them at low costs. The Bank of Japan started reducing the official discount rate from July 1991, and gradually lowered it to 0.5 percent in September 1995.[17] As a result, banks' current earnings increased, but not to the extent that the non-performing loans could be offset. First, their true magnitudes were not disclosed. Second, regardless of what was disclosed, the true amounts were increasing.

This economic distress can be explained by the fall of land prices, despite the government's claim that it should not affect the economy. The analysis presented by the government is flawed by taking an extraordinarily long time series data for the analysis. This result is contradicted by a more recent analysis by Mera(1996). Using quarterly data from 1986 through 1993, the change in personal consumption was explained by the change of three variables; worker compensation, the Nikkei stock index, and land price with certain time lags. Then, it was shown that the change in personal consumption can best be explained by the change in worker compensation and the land price with a time lag of two quarters. Both coefficients are positive and statistically significant.[18]

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[17] Bank of Japan(1997).

[18] The best estimate of the equation is:

$$C(t) = .353 + \underset{(3.30)}{.471}\, Y(t-2) + \underset{(0.78)}{0.10}\, S(t-2) + \underset{(2.19)}{.054}\, L(t-2) \qquad \text{R sq.} = 0.479$$

where C, Y, S, and L are the percentage change of personal consumption, workers compensation, the Nikkei index, and the representative land price, and t represents time in quarter, and the value in the parenthesis is the t-value.

The contraction of private consumption can therefore be explained as follows: once a robust economy was turned into a stagnant one with such measures as high interest rates and higher taxes, the workers compensation ceased to grow as much as it used to, and land prices ceased rising and began falling. When this trend continued, job security was threatened, and many households who purchased homes in the late 1980s lost the equity in their homes, adding to their overall unease and insecurity. These fears prompted a further reduction in consumption.

On the corporate side, the story was similar. Due to the decline in demand for goods and services, many corporate borrowers ceased to service debts, and began to reduce their investment expenditures. Such actions further reduced the aggregate demand of the economy. In the absence of reliable borrowers, many banks lent to non-performing borrowers, thereby leading to further increases in the amount of bad loans.

To overcome this economic difficulty, the government used public funds to stimulate the economy. The Miyazawa administration, fully aware of the economic slump, announced an urgent economic stimulus package totalling 13 trillion yen in April 1993. Since then, the volume of public sector spending increased consistently, culminating in a 23 trillion yen package in November 1998. Both politicians and bureaucrats had to admit that the situation was worsening during this period.

As late as 1994, the Economic Planning Agency (1994) recognized the importance of corporate and banking balance sheets as a critical factor affecting the health of the economy. It discussed in some detail the problems arising from non-performing loans, reporting that the total amount of non-performing loans held by all types of banks was about 8 trillion yen at the end of March 1992, 12.8 trillion yen at the end of March 1993, and 13.6 trillion yen at the end of March 1994. The proportion of non-performing loans to total assets at the end of March 1994 was reported to be 1.75 percent. Many analysts speculated that the magnitude of bad loans was much greater.[19] The Ministry of Finance announced in 1996 for the first time a more realistic estimate of the size of non-performing loans held by all types of banks: nearly 35 trillion yen at the end of September 1996.[20] However, this amount was also an underestimate. The newly established Monetary Supervisory Agency announced in July 1998 that the total of those loans held by all financial institutions in the country which may have problems in repayment stood at 87 trillion yen at the

[19] Economic Planning Agency(1994), p.221.

[20] Economic Planning Agency(1997). p.103.

end of March 1998.[21] Of course, a large part of the increase was due to the adoption of stricter definitions of non-performing loans. Some may argue that the Ministry of Finance was adopting more generous definitions in order to give an impression to the public that the bad loan issue was not really so serious.

The Ministry of Finance was consistently reluctant to reveal the true magnitude of non-performing loans. It never acknowledged that the current banking problem is a direct result of its policy of reducing land price. The Japanese bureaucrats have no incentive to be responsible for their collective actions. They are not held accountable in any way because they usually act behind the scenes of the Ministry or the Deliberation Council. However, these high level bureaucrats are the true architects of Japan's policy measures over the past decade. It is they who produce a scenario and who then lead the Minister and the Deliberation Council to perform accordingly.

These silent forces tried to solve the problem of economic stagnation by providing cheap money to banks and helping them to produce large current earnings so that they could write off bad loans quickly. However, the size of the problem was out of all proportion to what they could do with increased earnings. Moreover, banks were cushioned by the Ministry to the harsher effects of economic adjustment, and did not do the kind of restructuring that less protected companies went through such as reducing the number of employees, and cutting costs wherever possible. Banks continue to have significantly higher salary levels than among comparable industries in Japan.[22]

Public discontent and frustration over these trends was in part appeased through support given to the prosecution of several criminal cases involving high ministerial officials and executives in securities companies. During 1998 alone, several MOF officials were arrested, found guilty and sentenced. Another expression of public opinion was the choice of a slogan for the Lower House election in the fall of 1996. Fed up with irregularities demonstrated by public officials, and recognizing that bureaucrats were able to use their discretionary power of regulatory laws to their own advantage, voters favored deregulation as the first priority. Ryutaro Hashimoto, Prime Minister at that time, announced that he would do his utmost to deregulate the economy, declaring that the Big Bang would be completed in the

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[21] Nihon Keizai Shinbum, July 18, 1998

[22] The salary level of middle-aged workers in the banks and trust banks is 16% higher than their counterpart in all industries. Source: Nihon Keizai Shinbum, November 27, 1998.

financial sector by 2001. In addition, he promised to reorganize the chief administrative organizations and to reduce the number of ministries drastically. One exception was the powerful Ministry of Finance. It was decided to split it into two units, one in charge of fiscal issues and another in charge of monetary issues. Although the Japanese economy needs drastic deregulation for encouraging innovation and promoting new types of business activities, his choice of deregulation as the first priority in fact delayed actions needed for cleaning up bad loans that plagued all financial institutions in Japan. He was, perhaps, not properly informed about the gravity of that problem by MOF bureaucrats. Apparently, the Ministry of Finance at that time emphasized the importance of deregulation for the purpose of strengthening the competitive power of Japanese banks. Definitely, bureaucrats in the Ministry were reluctant to discuss the mess that they themselves had helped to create.

In the meantime, the Ministry pushed forward two measures that would increase government revenues at the cost of taxpayers. One was to increase the consumption tax from 3 percent to 5 percent, and another was to rescind the temporary tax relief that was enacted earlier to encourage consumers to spend more. These measures became effective as of April, 1997. This was the second major mistake that the Ministry of Finance made during the decade. To the fragile economy, the impact was unambiguous. Consumption fell, and bankruptcies and unemployment increased. The most dramatic event was the fall of one of the most established securities companies, Yamaichi Securities, in November 1997. This event cooled down the economy markedly. At that point, practically no company in Japan felt immune to bankruptcy. After Yamaichi decided to close the company voluntarily, a black dealing of Yamaichi with the Ministry of Finance leaked out. According to newspaper reports, the Ministry was giving advice to Yamaichi about how to hide losses incurred in securities dealings. Not only was the Ministry reluctant to disclose losses made by securities companies, it was also helping to hide such vital information.

In fact, the Ministry of Finance was manipulating the banking crisis through guided mergers of banks. When a bank approached a critical situation, the Ministry designated a partner for merger. In this way, the banking crisis was not perceived by the public as a major economic crisis. However, in the case of Yamaichi, no other securities company agreed to merge with it, as the pending loss was so large. The Ministry was unable to hide the problem from the public.

To summarize, the key linkages of the land price with the economy in the recent case of Japan can be described as follows:

- During the upswing of the 1980s, high land prices were supported by low interest rates and increasing demand for central locations. Rising land prices in turn helped to support increased consumption (due to wealth effects) and to increase investment in physical assets (due to increased collateral value). These increases in aggregate demand through consumption and investment further stimulated land prices. This rising spiral of aggregate demand and land price increases continued until1990.
- The government made a bold decision around 1990 to deflate land prices, and to this end it increased interest rates, regulated property-related lending, and strengthened significantly land-related taxes.
- The policy package was effective in deflating land prices, but this fall in land prices itself started to reduce consumption (counter-wealth effect). In addition, high interest rates and heavier taxation affected adversely business corporations. Many borrowers became unable to service debts adequately, and so the number of bankruptcies increased, and significant portions of bank loans turned into non-performing loans. Such negative economic factors helped to further depress land prices. A downward spiral emerged.
- Once this negative spiral has gained momentum, it is difficult to reverse. Massive public spending or low interest rates do not help the economy to recover or stabilize. In addition, when the magnitudes of the problems are not fully disclosed, as in Japan, companies and people are not able to take appropriate measures. They may be overly optimistic, in tune with the Government's own prognostications, and so may be caught unawares by further downturns. Or, lack of accurate information may cause them to be overly cautious and to save excessively, thereby depressing the current account of the economy even further.

The Economic Cost of the Recession

The economic cost of the current recession in Japan can be measured by the foregone output resulting from underutilization of productive capacities. The Economic Planning Agency (1994) estimated that actual GDP had fallen short of the economy's productive capacity by 6.3 percent at the end of 1993.[23] On this basis, Mera (1996) estimated the total economic cost to date of this recession to be about $1 trillion. If the recession were to much linger, it could well reach $ 2 trillion, which is about one half of the annual GDP for Japan. However as far as the manufacturing sector is concerned, the capacity utilization rate fell

[23] p. 146.

from 1990 to 1994 by more than 15 percent, and has been consistently below ninety percent utilitization rate since 1992 (see table 3). If this experience were applied to the entire economy, the loss of GDP from1992 to 1998 would exceed 70 percent of annual GDP. As the current GDP of Japan is 500 trillion yen (about $4 trillion), this translates to a cumulative loss of output in the order of $2.8 trillion to date. Moreover, as it may take some years yet for the economy to recover fully, the total loss promises to be much greater still.

Recent Actions by the Japanese Government

The fall of Yamaichi opened the eyes of many observers, including those outside of the country. Concurrently, the financial crisis that erupted in July 1997 in Thailand spread to other Southeast Asian countries such as the Philippines, Malaysia, and Indonesia. By the end of the year, the Republic of Korea joined the unlucky group. For many Japanese companies that were already weakened by unmanageable debt loads, and who had invested heavily in those affected countries, the East Asian economic crisis was a critical blow. The sluggish Japanese economy was itself a contributing factor for the lost momentum of these East Asian economies, as many Japanese firms and individuals have been cutting back their imports as the local economy stagnated. As a result, many in the industrial world feared that the world economy would lapse into a serious recession or even a depression if Japan failed to reverse the declining trend of its economy.

Senior U. S. officials expressed these views to their Japanese counterparts. In particular, Treasury Secretary Robert E. Rubin shared his serious concern about the Japanese economy in general and the non-performing loans held by Japanese banks in particular to Finance Minister Mitsuru Matsunaga when they met in London in May 1998, and to Finance Minister Kiichi Miyazawa in San Francisco in September 1998 when the newly appointed Finance Minister came to see him there. At the G7 Finance Minister/Central Bank Governors Meeting in London in October 1998, they announced a joint communiqué stating that Japan should stabilize its financial system by providing necessary public support to financial institutions as Japan's economic recovery is vital for the regional and world economies.[24] At

[24] Nihon Keizai Shinbum, October 5, 1998.

the meeting of the Asia Pacific Economic Conference the following month, the heads of the states in the region also endorsed the need for the Japanese government to stabilize its financial system.[25]

Despite consistent and long-lasting pressures from outside, the crucial event in reshaping the Japanese government's response to its economic crisis was the defeat of the Liberal Democratic Party led by Ryutaro Hashimoto in the Upper House election of July 1998. The LDP failed to take a majority and the Democratic Party led by a charismatic leader, Naoto Kan, made substantial gains. Taking responsibility for the defeat, Hashimoto resigned from the post of Prime Minister. Whoever was to succeed him, the unavoidable issue was now the handling of the banking crisis and economic recovery.

Three candidates for Prime Minister from the LDP debated about the issues. Keizo Obuchi won the race not because of his position on the issues, but because he inherited a large faction within the party. Nonetheless, his mandate was clear: he had to solve the banking crisis, and place the economy on the track to recovery. Two general approaches were proposed by politicians and financial experts engaged in this debate; one was in favor of a hard landing, while the other favored a soft landing.

The hard landing approach argues in favor of strict and regular rules of financial accounting to all banks, and to let any bank fail that cannot sustain itself under such a regime. All fixed deposits will be guaranteed by the Japanese Government up to a certain amount. This is basically an application of the approach taken by the Resolution Trust Corporation of the United States from the late 1980s to the early 1990s as described in chapter xx. It was highly successful in cleaning up bad Savings and Loans Associations (see Chapter x for more detail). By adopting the same strict, dispassionate methods employed in cleaning up the U.S. Savings & Loans crisis, the hard liners argued, the Japanese banking crisis would be resolved more swiftly.

The soft landing approach was promoted by those who thought the hard landing approach was too drastic and would impact the Japanese economy severely and enduringly. One distinct feature of the Japanese banking crisis was its scale. In the United States, only some of the Savings & Loans Associations were impacted. Total deposits of those troubled institutions were merely a fraction of GDP in the United States, whereas in Japan the problem was much more deeply rooted. Not only were small and medium

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[25] Nihon Keizai Shinbum, November 18, 1998.

banks and other financial institutions affected, but major banks were also in serious trouble. Based on a total volume of non-performing loans in the order of 86 trillion yen, the affected loans comprise well over seventeen percent of all loans held by Japanese banks in 1998.[26] In the Japanese system, major banks regularly finance large groups of companies, often called *keiretsu* and many companies are highly dependent on financing from these banks. Thus, if a major bank fails, most of the companies in the keiretsu would fail as well. Moreover, if a major bank were to fail, it would have a contagious effect on other banks as well. Therefore, the RTC method could be thought of as too drastic for the Japanese case. Many politicians, not only LDP politicians but also some others, favored the soft landing approach in which major banks were to be saved with an infusion of public funds rather than letting them fail.

After long debates and inter-party battles, Obuchi succeeded in the middle of October 1998 in passing a bill authorizing 60 trillion yen of public funding for strengthening the capital base of major banks and guaranteeing the deposits of failed banks. Then, in November the Obuchi administration succeeded in passing a bill authorizing a 23.9 trillion yen economic stimulus package including public spending increases and tax cuts. Although the problem has not yet been fully solved and this remedy might delay fundamental restructuring of Japanese banks, major banks ought to be able to resume their normal lending activities for the first time in several years. In response to these measures, the Nikkei Stock Index returned to the15,000 level by November from the previous low of 13,000 recorded in October.

What distinguishes the political process observed in 1998 from those observed in the years before is the fact that publicly elected politicians themselves prepared and produced alternative measures rather than taking draft measures prepared by bureaucrats in the Ministry of Finance. This seemingly innocuous change in process was a tremendous achievement for the elected politicians. The remedies for the banks and the economy may not be sufficient, as some critics argue. They have not specified in sufficient detail how and when the non-performing loans should be removed from the books, nor how the deflationary spiral could be terminated. Nonetheless, this crisis did have a salutary effect on how elected officials viewed their own responsibilities with respect to policy decisions affecting the macroeconomy and its financial system.

[26] The total amount of loans and discounts held by banks was 481 trillion yen in July, 1998 (Bank of Japan, September1998).

Lessons Learned from the Japanese Experience

The Japanese experience provides a number of valuable lessons to other countries. They include:

- After an economy has been successful for a long sustained period; such as the case of Japan in the 1980s, which surpassed most industrialized countries in per capita GDP; business people, including those in banking, gain confidence in the infallibility of their own styles of business management. As they do, they begin to show disregard for normal due diligence. This common phenomenon may be termed an *arrogance effect*. To guard against this arrogance effect, the Japanese experience needs to be told widely and frequently to business people.
- The institutional framework for decision-making should be designed in such a way that decision-makers are held accountable for their decisions. In Japan, their seemingly immaculate past track record enabled Japanese bureaucrats to avoid such accountability. Inevitably, this situation will result in serious mistakes in policy making followed by a reluctance to come to terms with those mistakes.
- Land value is a fundamental basis for bank lending, particularly in Asia. Therefore, significant drops in the price of land materially affect the financial underpinning of the entire economy. Thus, governments should strive to avoid a sudden fall in land prices to the extent possible. The current Japanese recession was initiated by a deliberate attempt by the Japanese government to lower the price of land.
- Withholding critical information may lead to a far more serious situation in the long-run. The cost of ignorance is grave. Regardless of possible adverse implications to politically influential groups of people, a system of information disclosure should be established and firmly maintained.
- The real estate sector plays an important role, not only for providing space to accommodate economic and social activities, but also for helping to provide credit for expanding economic activities. A reduction of the overall land price is therefore likely to depress the level of economic activity generally, as was observed in Japan.
- The banking sector is crucial for the proper functioning of the economy. Once the banking sector becomes unable to extend loans to healthy companies in support of viable, productive economic activity, the entire economy will suffer and suffer seriously.
- Through globalization of the economy, trouble that starts in one country cannot be contained within it. One country's problem is immediately transmitted to others. Therefore, international coordination is crucial for maintaining a healthy economic situation for any country.

TABLE 1

GDP Growth and Other Major Economic Indicators

Year	Land Price Rise(%)(a)	GDP Grwth(b) (%)	Cons. Prop.(c) (%)	Capacity Ulitilz. Index(d)	Unempl. Rate(e) (%)
1985	2.2	5.2	77.5	96.1	2.6
1986	7.6	2.6	77.4	91.7	2.8
1987	25.0	4.1	76.4	91.8	2.8
1988	7.9	6.2	75.7	97.1	2.5
1989	17.0	4.8	75.1	99.0	2.3
1990	10.7	5.1	75.3	100.0	2.1
1991	-5.6	4.0	74.5	98.0	2.1
1992	-8.7	1.1	74.5	89.9	2.2
1993	-4.7	0.1	74.3	84.3	2.5
1994	-1.6	0.5	73.4	84.2	2.9
1995	-2.6	1.5	72.5	86.1	3.2
1996	-1.6	3.9	72.0	86.9	3.4
1997	-1.4	2.5	72.0	89.8	3.4
1998	-3.8	-2.8	71.3	83.3	4.1

Note:

a. Annual change of residential land price for the entire country measured on the fisrt day of the year, published by the Land Agency. Unlike most publications, the figure is assigned to the year preceding the new year’s day, as it means that.

b. The figure is for the calendar year.

c. Consumption propensity of the working households based on a survey conducted by the Management and Coordination Agency.

d. Index is set to be 100 for 1990. Based on a survey by the Ministry of International Trade and Industry.

e. Ratio of wholly unemployed persons. Based on records kept by the Ministry of Labor.

Source: Bank of Japan (1995) and Bank of Japan (September 1998).

TABLE 2

List of Economic Stimulus Packages Announced by the Government of Japan

Month, Year	Size in trillion yen
August 1992	10.7
April 1993	13.2
September 1993	6.2
February 1994	15.2
April 1995	7.0
September 1995	7.0
April 1998	16.0
November 1998	23.9

Note: This list excludes public fund allocation for rescuing banks.

Source: Nihon Keizai Shinbum

TABLE 3

Sources of GDP Growth: Private, Public and Trade Sectors Contributions

Year(a)	GDP Grwth (%)	Private Sector	Public Sector	Net External Demand
1985	4.1	3.9	-0.4	0.5
1986	3.1	3.0	0.9	-0.8
1987	4.8	5.0	0.8	-1.0
1988	6.0	6.7	0.2	-0.8
1989	4.4	4.7	0.3	-0.6
1990	5.6	4.7	0.5	0.3
1991	3.1	1.7	0.6	0.9
1992	0.4	-1.6	1.3	0.6
1993	0.5	-0.6	1.2	-0.1
1994	0.6	0.7	0.3	-0.3
1995	3.0	3.0	1.0	-1.0
1996	4.4	4.4	0.0	-0.0
1997	-0.4	-1.4	-0.4	1.4
1998	-2.8(b)			

Note:

a. Fiscal year starting April 1 and ending March 31 of the following year, unless otherwise noted.

b. For calendar year

Sources: Bank of Japan, Economic Statistics Annual, and Economic Statistics Monthly, Research and Statistics Department, Bank of Japan.

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