Financial Troubles: Japan in the 1990s, the United States Today

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Abstract

This essay comparing and contrasting the financial crises in Japan in the 1990s and the United States today is a slightly modified version of an essay written for the 2008 annual report of the Center for Japan-U.S. Business and Economic Studies at the Stern School of Business. It deals with an issue much on the minds of Japanese observers of the United States, who are worried that the U.S. economy is entering into a “lost decade” similar to that experienced by Japan from 1992 to 2002, characterized by very low economic growth with multiple recessions, enormous non-performing loans and collapse of financial institutions, and deflation. This paper argues that there are some similarities in the two cases, but that the differences dominate. The American problems continue to evolve (this paper was written in August, 2008), but the problems are unlikely to be as serious or long-lasting as in Japan. This conclusion does not imply that the situation in the United States is not serious, since the financial sector is coping with a crisis larger than any since the Great Depression. However, in a relative sense the U.S. economy will not be as deeply affected as was the Japanese economy. This conclusion follows mainly from the smaller size of the underlying bubble and collapse in the real estate market and the much quicker responses in revealing problems and devising responses.
Introduction

Comparison of economic developments in Japan and the United States is one of the core functions of the Center for Japan-U.S. Business and Economic Studies. The past year was dominated by the emergence of the sub-prime mortgage problem in the United States. A major question in the minds of many Japanese has been whether the U.S. problems will turn out to be a repeat of those in Japan during the 1990s. This question dominated the two gatherings of Japanese business people hosted by the Center during the year (The New York Market Conference described under events). The drop in the real estate and stock markets in Japan at the beginning of the 1990s triggered a “lost decade” of very low growth, deflation, huge non-performing loans, bank collapses, and rising unemployment. Observing what appears to be a rather similar real estate and stock market collapse in the United States, many Japanese have been worried that this will lead to a similar prolonged period of economic distress. The annual essay this year addresses this question, arguing that, despite some similarities, the United States is very unlikely to repeat Japan’s experience.

Similarities

Some similarities between the situations in Japan and the United States cannot be denied, and provide sobering lessons in the nature of financial crises in any economy. These similarities are especially salient given the fact that, at the time, Americans tended to believe that the situation in Japan was caused by peculiar characteristics of the Japanese economy, that are quite different from anything found in the U.S. economy.
While this essay will emphasize a number of those differences, there are some similarities providing a reminder that no economy is immune to mistakes and problems.

**Speculative Bubble and Collapse:** In both cases, the catalyst of economic problems came from a speculative bubble and subsequent collapse in asset prices. In the case of Japan, the stock market rose sharply from 1985 to the very end of 1989, and then declined sharply. The real estate market, as measured by the price for property in the six largest urban areas of Japan, also rose, reaching a peak in 1991, followed by a sustained drop. In the case of the United States, the speculative bubble was more apparent in the real estate market than the stock market, but as the sub-prime mortgage situation was revealed, it had a severe impact on the stock market as well.

In both Japan and the United States, asset price decline has also had strong, broad, economic effects. Banks in Japan that lent heavily to real estate developers and stock market speculators lost heavily, as did financial institutions in the United States that were heavily invested in the sub-prime mortgage market through purchase of asset-backed securities. In both cases the economic impact eventually spread broadly through the economy. Economies are enormously complex systems in which problems in one sector can affect the rest of the economy through a myriad of linkages.

**Ties to Monetary Policy:** In both economies, the emergence of a speculative bubble and its collapse was related to monetary policy. Fundamentally, the bubble in Japan was caused by an unusually expansive monetary policy in the wake of the sharp appreciation of the yen against the dollar after 1985. Fearful that yen appreciation would push the economy into recession, monetary authorities aggressively lowered interest rates. Equally important, they used “administrative guidance” to the banks to increase
their lending. When banks found that many of their traditional borrowers, manufacturing firms, were not eager to increase borrowings since their growth and profits had been hit badly by yen appreciation, they turned with government approval to real estate lending.

In the United States, interest rates had been relatively low since the mid-1990s (and especially low at the time of the 2001 recession). While low interest rates were not the only cause of U.S. problems (which were uniquely tied to the creation and expansion of sub-prime mortgages), low interest rates certainly helped fuel the rise in real estate prices and implied that borrowers with adjustable-rate mortgages would be vulnerable should interest rates rise.

Having fueled the bubbles, monetary policy also explains the “bursting” of the bubbles. In Japan, authorities finally became concerned about the possibility of a speculative bubble in 1989, and began raising interest rates. This was followed by administrative guidance in 1991 to banks to stop increasing their lending to real estate. In the United States, tightened monetary policy was not motivated by a desire to prick a speculative bubble, but rather to combat rising general inflation in the economy; the effect was the same.

Unethical/Illegal Behavior: In both economies, the period of the speculative bubble involved extensive unethical and/or outright illegal behavior that exacerbated the bubbles. In Japan, a considerable (though unknown) portion of mortgages written in the second half of the 1980s were to yakuza-connected borrowers. With real estate and the stock market rising so rapidly, investments in both became a convenient way for the criminal underworld to launder its ill-gotten gains into lucrative legitimate investments. In addition, Japanese banks lent money with an extraordinary disregard for the financial
soundness of the borrowers. One of the many sordid tales of the era was that of Mrs. Onoue, an owner of a small restaurant in Osaka. She was borrowing heavily from major banks to speculate in the stock market, using the same certificates of deposit as collateral over and over. When the stock market collapsed, she went bankrupt with outstanding bank loans that amounted to the equivalent of $3 billion. It is inconceivable that the banks were unaware of what she was doing, but lent her these huge amounts of money anyway.¹

In the United States, the tale of sub-prime mortgages has been replete with stories of mortgage firms similarly disregarding or deliberately falsifying the financial information concerning borrowers, thereby enabling mortgages to individuals with a high likelihood of defaulting. In 2008, two former executives of the failed investment bank Bear Sterns were arrested for falsifying the health of their sub-prime hedge fund, as were some 300 people around the country (for various fraudulent behavior in writing mortgages).²

In neither country does unethical and illegal behavior completely explain the existence of the speculative bubble; bubbles have a dynamic that need not involve such additional problems. Expansive monetary policy, discussed earlier, played a role in creating the bubbles as well. Nevertheless, the prospect of quick and large financial gains appears to contribute to, at best, very lax behavior of many of those in the market; and at


worst, illegal efforts to enhance gains, which certainly contributed to the severity of the overall outcomes.

**Arrogance:** In both countries, financial institutions claimed that they knew exactly what was happening, and that there were no problems and no bubble (until it actually burst). The leaders of commercial banks and investment banks believed that they were true masters of the arcane world of finance, able to create high returns with limited risk.

In Japan the arrogance came from more than 30 years of regulated life, during which the government had guaranteed profits through control of interest rates and a prohibition on new entrants. With that record of success in the past, bankers faced a somewhat deregulated market in the 1980s with gusto. Measured by total assets, Japanese banks were among the largest in the world, and the bankers seemed to equate asset size with skill and success. They also believed that their new market interest—real estate—was simple: real estate prices had fallen in Japan only twice previously in the 20th century (at the end of the war in 1945 and in the sharp recession of 1974) for very brief periods of time. With piles of cash to lend, and a market that always went up, how could they lose?

A somewhat similar hubris infected investment banks and stock market investors. Investment banks were so confident that Nomura Securities, the largest broker in Japan, at one time offered a limited number of privileged VIP clients a sizable guaranteed return on their stock market investments (until the market crashed and the guarantees were revealed in the press).
In the United States, the hubris had somewhat stronger theoretical underpinnings. Since the early 1970s, investment theory has undergone important advances, with the rise of sophisticated mathematical models of risk and return. On the positive side, these theoretical advances led to a variety of new financial instruments and markets (including junk bonds and hedge funds) that have been largely positive. However, especially during the years prior to the sub-prime debacle, there was a disturbing rise of implicit belief that sophistication and innovation meant higher returns without higher risk. The notion that, for example, taking a collection of mortgages and bundling them into various asset-backed securities in which levels of risk are divided and spread among the securities leads to a more stable and less risky market was quite popular. The eventual collapse of the sub-prime market proved otherwise.

The lesson in this similarity is that investors and individuals generally should be skeptical of arrogant portfolio managers and other managers at financial institutions. While it is certainly correct that higher risk investments should yield a higher rate of return over long periods of time, it remains possible to underestimate risk and to be surprised when the downside risks are actually realized. When returns rise, and expectations of risk about these investments remain subdued, everyone should be worried.

**Underestimation:** In both countries, the initial signs of problems were largely dismissed as minor blips. My own interviews with Ministry of Finance officials as late as 1993 indicated that they expected the economy to recover from a temporary drop in the rate of growth by the following year. Non-financial businesses continued to operate as if they shared the expectation of a return of high growth until 1997, by continuing to hire...
additional workers and build additional capacity. The successful economic growth experience of the late 1980s and the belief that it was rooted in the nature of the Japanese economic system blinded both authorities and businesses to the reality of an unfolding economic crisis. Not until 1997-98 did the government and private sector finally come to grips with the reality of the situation—six to seven years after the problems began.

In the United States, initial expectations in the summer of 2007 were that the sub-prime mortgage problem would have a limited impact on the economy. In this case, the blindness may have been due to ignorance by those outside the mortgage market about the size of the sub-prime business and the risky manner in which players were behaving. Few knew that these mortgages had become a very large share of the new mortgages written in the previous several years. Instead, the predominant mood had been one of pride that the share of households owning their own dwelling was rising to an historic high. That the sub-prime borrowers were a significantly large enough share of new mortgages as to cause a broader impact on real estate prices and the rest of the economy as borrowers defaulted was quite a shock.

**Government Rescues:** In both countries, the problems required explicit government action to bail out the financial system, and in both cases doing so was controversial. Although the economic systems in Japan and the United States are somewhat different, both are market-based economies, in which private sector firms dominate and the government is supposed to establish the rules and let markets determine outcomes. But the danger of broader financial collapse was considered sufficiently large that in both countries the government intervened to take over failed institutions, prop up others, or otherwise interfere in normal private-sector outcomes.
In Japan, the 1980s had been a decade in which government enterprises were privatized, and government regulation of the financial sector was eased. The public therefore, was initially outraged at the idea of taxpayers’ money being used to bail out the losses incurred by a group of non-bank real estate lending subsidiaries (jusen) of the major banks that collapsed in 1995. In the end, the government passed new legislation in 1998 to temporarily nationalize failed banks, and to invest new capital into major commercial banks to keep them from failing.

In the United States, the Federal Reserve played the role of go-between in arranging the takeover of Bear Sterns by J. P. Morgan, and then opened its discount window to investment banks (something never done before). The federal government then stepped in to prop up Fannie Mae and Freddie Mac (the two very large private but government-affiliated mortgage securitization firms). As in Japan, the rationale was that failure to act could lead to a broader round of failures in the financial sector, creating a credit crunch that would harm the whole economy.

At question are competing issues: moral hazard versus financial stability. If investors believe that government will always step in, then they will engage in more risky behavior. On the other hand, the cost to the economy of broad financial failure could be daunting. The best one can say is the example of both countries suggests an ad hoc nature to bailouts (so that investors should not be able to always count on protection), and a process in which some investors do incur large losses. In Japan, for example, the shareholders of the Long-Term Credit Bank (the largest bank to fail) lost virtually everything. In the United States, shareholders of Bear Sterns, Lehman Brothers, Fannie Mae and Freddie Mac also experienced severe losses. Despite this debate continues to
rage over the issue of whether or not managers and shareholders of troubled financial institutions are paying a sufficient price for their mistakes.

**Differences**

The similarities between the crises in the United States and Japan notwithstanding, the differences are critical. These differences illustrate a number of the major distinctions in institutions and behavior of the two economies at the time the crises emerged.

**Scale:** The scale of the real estate and stock market bubbles was much larger in Japan than the United States. On the downside, the U.S. situation continues to evolve, but there is no expectation that the declines in these markets could be as severe as those in Japan.

In Japan the Nikkei Index for the Tokyo Stock Exchange tripled in value from 1985 to the end of 1989 (see figure 1). All of the gains were then lost, and as of the summer of 2008 this market index was actually back to the level of late 1985 (after some recovery in the previous three years). From the peak at the end of 1989, the decline in stock prices to the trough in 2002 was a huge 78 percent (and even during the summer of 2008 the index was still 65 percent below the peak).

In Japan’s urban real estate market (measured by the price index for the six largest metropolitan areas), prices also tripled between 1985 and 1991, and then lost all of those gains. From peak to trough, the decline in urban real estate prices was a whopping 76 percent. As of 2007, urban real estate values were still 20 percent below the level of 1985. As an American, just imagine holding a stock portfolio that failed to increase over
a 28-year period, or owning a house worth less after a 25 year period, or buying at the peak of either market and losing three-quarters of the initial value!

In the United States, the increase of real estate prices in the 10 largest urban areas rose by 125 percent from the beginning of 2000 to mid-2006, and subsequently declined by 20 percent by mid-2008 (Standard and Poor’s Schiller-Case Index of real estate values), as shown in figure 2. The broader U.S. government estimate of median real estate prices did not even double (rising 64 percent from 2000 to a peak in early 2007) and declined much less (5 percent).
To be sure, the real estate bubble in Japan was concentrated in the largest urban areas as well, but the point remains that the increase in real estate values in the United States, while large, was considerably less than in Japan. As of the summer of 2006, further declines in U.S. real estate prices were being forecast, but no forecasters expected a collapse of Japanese proportions. At most, a further decline of five to ten percent appeared possible. With a bubble that was not as elevated, and a smaller decline in prices from the peak, the relative loss in asset values to be absorbed by the economic system was far less in the United States.

Sources: Standard and Poor’s, “S&P/Case-Shiller Home Price Indices,” http://www2.standardandpoors.com/portal/site/sp/en/us/page.topic/indices_csmahp/0,0,0,0,0,0,0,0,0,1,1,0,0,0,0,0,0.html (August 16, 2008); Office of Federal Housing Enterprise Oversight, Monthly House Prices Indexes, ttp://www.ofheo.gov/hpi_download.aspx (August 16, 2008); Yahoo! Finance, “S&P 500 Index,”
All of these observations concerning the real estate market apply to the stock market as well. Indeed, there is little evidence that the U.S. stock market experienced any speculative bubble. The market had been inflated at the end of the 1990s, due to the dot-com bubble, and declined until the end of 2002. From that trough, the rise to the peak in 2007 for the S&P 500 index was only 82 percent. Furthermore, the increase from the previous peak in August 2000 to the new peak in October 2007 was only 2 percent. From the peak in 2007, the decline to the summer of 2008 was 18 percent (with further declines thereafter), enough to officially declare a “bear market,” but hardly in league with the declines in the Tokyo Stock market. Further declines are possible, but no analysts anticipate a repeat of Japan’s experience.

These differences are important. With smaller relative increases on the upside, and smaller relative declines, the United States faced a loss of asset values considerably smaller (relative to the size of the economy) than did Japan in the 1990s. With a smaller problem to deal with, the United States faced the prospect of working through it more quickly and with less overall negative impact on the economy.

**Rapid Exposure:** One of the factors that caused the problems in Japan to continue for such a long time, and to have such a negative impact on the economy, was the very slow revelation of the facts. As with a doctor treating a patient, the first step is diagnosis, and that depends on accurate data. In the United States, in contrast, disclosure of losses and other details of the sub-prime problem proceeded quite quickly.

In Japan the commercial banks (with implicit or explicit government approval) failed to reveal the true extent of their bad loan problems until the end of the 1990s.
When the troubles began, it had been the policy of the government to hide any bank problems from the public, out of concern that negative news would undermine public faith in the banking sector (where the bulk of household savings was invested). Furthermore, disclosure rules were weak and bank inspections infrequent and lax.

To be sure, in any economy facing a decline in asset prices, accountants have a problem in figuring out how to value assets on their books—a problem that has emerged in the United States. This problem arises from the uncertainty accountant’s face in adjusting the value of assets on the firm’s books when the market is turbulent and no one really knows the worth of an asset until it is actually sold. Nevertheless, there is clear evidence that banks in Japan willfully hid the extent of their problems. Banks that failed, such as the Long Term Credit Bank, were found to have established non-bank subsidiaries, to which they lent money to buy bad loans at face value from the bank. Such actions got the bad loans off the books of the bank, and as long as the subsidiary had enough cash from its initial capitalization, it could maintain monthly loan payments for a period of time.

The rationale for a system of deceit had been the belief, based on decades of high economic growth, that problems facing a bank in trouble were likely to be temporary, or that in a serious situation, the government could quietly arrange a takeover by a stronger bank. Problems in the years from the early 1950s through the late 1980s had been rare. Only the realization in 1997 that many banks were in trouble, and other banks were too weak to take them over, led the government to change its policies with new legislation in 1998. One of the changes was the creation of the Independent Financial Services Agency (FSA) in that year, taking bank supervision away from the Ministry of Finance.
of the FSA led toward better disclosure of the losses, though even with this change the
data on non-performing loans were not entirely believable until around 2001.

The contrast with the United States is startling. Housing prices began to fall in
the second half of 2006 (or early 2007 if one use’s the broader U.S. government’s median
house price data). Less than a year later, in the summer of 2007, financial institutions
began to reveal their losses. The following year brought a blizzard of negative
revelations. These institutions, too, faced the problem of pricing assets on their books of
uncertain value, prompting some fears in the market of losses greater than reported.
Nevertheless, the point is that American institutions were forced to reveal losses quite
promptly. This speed implied that the process of dealing with the damage could begin
more quickly as well, so that the problem was unlikely to linger as long as it did in Japan.

**Rapid Response:** The Bank of Japan had perhaps acted correctly by raising
interest rates to prick the speculative bubble, beginning in 1989. However, once asset
prices began falling, the Bank reacted rather slowly. The call rate (the inter-bank lending
rate that is the equivalent of the Federal Funds rate targeted by the Fed in U.S. monetary
policy) peaked at 8 percent in 1991. The bank began cutting this rate in late 1991 (almost
two years after the peak in the stock market, and as the real estate collapse was getting
underway), but reached 3 percent only two years later in August of 1993, a rather stately
pace of reduction, and 2 percent another year later (see figure 3). To be sure, the initial
level of short-term interests had been unusually high at 8 percent, making the decline in
rates appear quite steep, but in reality the cuts in rates took two-to-three years simply to
reach a potentially simulative level. The Bank of Japan later took stronger measures,
pushing the call rate to zero, but not until 1999. One of the principal consequences of the
slow response of monetary policy was that the economy slipped into a state of deflation—a general decline in prices (considered later in this essay).

![Figure 3: Drop in Interest Rates from Peak](image)

In contrast, the Federal Reserve reacted with great swiftness to the emerging sub-prime problem. Within 11 months, the federal funds rate dropped by two-thirds, from 5.25 percent to 2 percent. In Japan, the call rate did not reach two percent until 38 months after the Bank of Japan began cutting rates. While monetary policy alone was not sufficient to resolve the problems in either country, at least the Federal Reserve moved quickly to do what it could in the form of supplying stimulus to offset the negative impact of the sub-prime crisis, stimulus that was much slower to appear in the case of Japan’s crisis of the 1990s. The effectiveness of this stimulus was undermined in both countries.

by a credit crunch and/or liquidity trap; weak banks were reluctant to extend new credit as rates fell, and borrowers were loath to take on additional debt. Nevertheless, lowering interest rates was a part of the package of needed policies, and the Fed acted more quickly.

It is worth noting that in devising its monetary policy (and other policies) the Federal Reserve may have been well served by the experience of two of its key members. Fed Chairman Ben Bernanke studied and wrote about Japanese monetary policy in several published papers in the late 1990s. New York Federal Reserve Bank president Timothy Geithner served as the Treasury’s representative in the American Embassy in Tokyo in the late 1980s during the bubble years, and continued to be engaged in policy toward Japan through the 1990s, when he was back at the Treasury Department’s headquarters in Washington. The need for more prompt monetary policy response was a lesson that both of them drew from close observation of Japan.

**No Deflation:** Japan’s problems were further complicated by the emergence of deflation, defined as a general decline in prices, which lasted for a decade. The United States did not face any similar problem in the wake of the sub-prime crisis (though a very different problem, stagflation, was a conceivable possibility).

Modern economies live on debt. Some members of society spend less than they earn. Their unused income (savings) is transferred through the financial system to those members of society who need to spend more than they earn. Corporations building new plant and equipment, plus households buying homes are two of the most important elements in the economy needing to borrow from the savers. This process is how

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economies grow, so fostering an environment favorable to debt is useful. The problem with deflation is that it makes debt harder to repay. A corporation, for example, that borrowed on the basis of projections of future revenue from the new factory finds that the price of its output is falling, lowering the revenue stream from which it must repay its loans. Similarly, households find their incomes falling as well (since deflation implies all prices are falling—including wages and salaries). Furthermore, should the borrower default on the loan, the bank might not recover the full amount of the loan by selling the asset. The result is an economic environment in which both borrowers and lenders face potential losses.

A second problem with deflation is that it undermines the ability of monetary authorities to use expansive monetary policy to restore economic growth. Central banks can manipulate nominal interest rates (such as the federal funds rate in the United States, or the call rate in Japan). Central banks cannot force interest rates below zero (since everyone would prefer to hold cash than make an investment with a negative interest rate). But with deflation, a zero nominal interest rate is a positive real rate (the nominal rate adjusted for inflation), putting a limit on how low the central bank can push real rates.

As historical deflations go, Japan’s was rather mild. From the mid-1990s to 2007, the consumer price index was falling at a rate between zero and minus one percent a year (though economists argue that this index has an upward bias, so that actual consumer price deflation might have been larger). The GDP deflator indicated a somewhat higher deflation, between one and two percent a year. In 1997 both indicators briefly turned
positive, due to the hike in the national consumption (sales) tax from three percent to five percent. Nevertheless, this was enough to worry economists.

In contrast, the United States does not face any problem from deflation. First, the Fed reacted quickly in the recession of 2001-2002 when inflation was very low, partly out of knowledge of what had happened to Japan in the 1990s. Second, by the time the sub-prime mortgage crisis hit, inflation was already on the rise, driven by rising oil and other commodity prices. In fact, the concern in the U.S. by 2008 was that a very different problem could complicate the response to the financial crisis—stagflation similar to what occurred in the industrialized nations in the 1970s. Economists associate higher inflation with strong economic growth, but the oil price shocks in the 1970’s created an unusual combination of high inflation (as the initial oil price shock fed through the economy to produce higher general inflation) and recession. In such a case, the government faces unsettling choices. Economic stimulus policy to end the recession exacerbates the inflation and austerity to control inflation worsens the recession.

Should stagflation be a serious concern in the United States? As higher oil prices begin to filter through the economic system, causing firms to raise other prices, this is a legitimate concern. However, there are important differences between the 1970s and now. Labor unions are considerably weaker, and combined with increased international competition; firms are less likely than they were in the 1970s to respond to rising prices by agreeing to increased wages and salaries for their workers. The pass-through of the initial price impulse from oil through increased wages had been a crucial part of the linkages in the 1970s. In addition, the Federal Reserve is unlikely to be as accommodating to inflation this time, and was already voicing its concerns about
inflation by mid-2008. Should the Federal Reserve raise interest rates in order to choke off inflation, this could slow the recovery from the sub-prime debacle.

**Slow Structural Adjustment:** Recovery in Japan was further complicated by the slow response of the non-financial sector to new conditions. For several years after the start of the collapse in the stock and real estate markets, firms believed that the downturn in asset prices and in real economic growth would be very temporary, after which the economy would return to a growth close to that of the late 1980s. On that basis they continued to invest and hire additional workers. Firms did not change their outlook until about 1997, and then entered a prolonged period of lowering investment, reducing debt, and shedding workers. This process lasted until approximately 2003, slowed in part by the difficulty of laying off “regular” employees; who are both the beneficiaries of unwritten “lifetime employment” practices in large firms, and legal requirements that firms must exhaust all other means of cutting costs before dismissing regular employees.

In the United States, in contrast, the reaction of the non-financial sector was relatively rapid. American labor markets are much more flexible (in terms of both custom and law). Total employment was falling in the United States by early 2008, only about a year into the evolution of the crisis. This flexibility, as painful as it was, suggests that the adjustment process in the United States will occur much more quickly, putting the economy in a position for economic recovery more quickly.

**Demographics:** The bubble in real estate prices in Japan occurred at a time when long-term demographic trends suggested that, at the very least; the trend in rising real estate prices should have moderated not accelerated. Due to a low and still falling birth rate, total population was barely growing by the 1990s (and began falling in 2006). But
the future trend was clearly going to be one of a falling number of households, which would lessen the overall demand for residential real estate. Therefore, by the time the collapse in real estate prices had run its course in 2005, there should have been little expectation of much overall increase in real estate prices nationwide. Prices in some markets, such as Tokyo, might rise as the population continued to shift from rural areas (or even outlying suburbs) into the city, but at the national level, demographics implied little if any further increase in demand.

In the United States, in contrast, the birth rate continues to hold at approximately the steady-state population level, and immigration adds to the total population. Even with a temporary decline in real estate prices in 2008, the underlying demographic trend implies increasing demand for housing. Therefore, it is highly unlikely that the decline in real estate prices would last very long, with prices bottoming out and beginning to recover within a year or two. With a moderate pace of increase, it might take several more years to return to the peak real estate prices of 2006. However, it is highly unlikely that households will find, like the Japanese in the 1990’s, that their homes will be worth no more in 2025, than now.

**Wealth Effect:** The final difference between Japan and the United States actually works in the opposite direction—an economic linkage that implies the downturn in the United States could be worse than in Japan. This factor is the wealth effect on households. In the United States, economists argue that household wealth has an impact on spending. This effect is facilitated in part by the ease with which households can borrow against the increased value of their homes in the form of a second mortgage or line of credit, often used to finance their children’s college education, a new car, or other
large purchases. Furthermore, American households hold a significant portion of their financial assets in the form of stocks and bonds. To the extent that households can expand spending on the basis of increased wealth, then the decline in the real estate market (and stock market) should have a negative impact on household spending. How important this effect might be, however, remains a contentious issue among economists.\footnote{On the wealth effect controversy see Christopher Flavelle, “Debunking the "Wealth Effect Declining house prices don't necessarily slow down consumer spending," \textit{Slate}, June 10, 2008, http://www.slate.com/id/2193287/ (August 15, 2008);}

In Japan, however, the second mortgage market was not as well developed. Furthermore, households held far less of their financial assets in the form of stocks and bonds. This meant that the wealth effect from the collapse of the real estate and stock markets was small. Of course, the drop in interest rates to near zero later in the 1990s, implied that households (especially retirees) experienced a decline in interest income, somewhat analogous to a wealth effect. Therefore, perhaps the wealth effect in the United States will not have an impact any more severe than the interest-income drop in Japan.

\textbf{Summary}

Some similarities between the financial problems in Japan and the United States must be acknowledged. Financial bubbles tend to be times of optimism, generating exaggerated beliefs about the robustness of the overall economic system. Arrogance, lax conditions fostering unethical and illegal behavior, and underestimation of the problem when the bubble bursts, all seem to be common aspects of such bubbles. After a decade
of hectoring the Japanese about the ills of their economy, Americans learned a bit of humility from the sub-prime crisis in the United States.

But in the final analysis, the differences between the two situations dominate. For all the reasons explored in this essay, the United States is very unlikely to repeat the “lost decade” of Japan. The economic system was not sufficiently robust to prevent the emergence of the crisis, but the smaller relative size of the underlying problem of declining asset values, the strong rules on disclosure, the quick response of monetary policy, the quick willingness of government to intervene, and the flexibility of labor markets all implied that the problems in the United States will not last as long as in Japan. Economic recovery in 2009 might be weak, with stronger recovery waiting until 2010, but even that would be a much quicker recovery than has been the case in Japan.