ACTIVITY 1
JAPAN'S LOST DECADE

Congratulations. You have been asked to join the President's Council of Economic Advisors. It has been a little over three years since the housing price bubble burst sending first real estate markets, then credit markets, and finally the overall economy into a tailspin. Although the crisis has been compared to the Great Depression, many economists believe our current situation has more in common with Japan's Lost Decade of 1991–2000.

Your first job is to learn about the Lost Decade. Read the following summary of the economy in Japan during this time. In subsequent activities, you will be asked to compare and contrast economic conditions during the Lost Decade and the financial crisis of 2007-2009. Next, you will use this information to identify potential problems facing the United States.

Japan's Lost Decade History

The Japanese economy was booming in the late 1980s. Strong demand for Japanese exports and extremely low interest rates fueled a speculative surge in both the stock and real estate markets. Fearing that real estate prices were not sustainable, the Japanese government burst the bubble by significantly increasing interest rates in 1989 and 1990. This led to a rapid decline in both land and equity prices.

Much of the boom in stocks and real estate was supported by debt, so the collapse in prices led to a credit crisis. Banks suffered massive losses as they were faced with rising default rates on loans. The government injected large sums of money into banks to keep them from failing. This was very controversial. On the one hand, many claimed that these banks were "too big to fail" and that letting them go bankrupt would have serious ripple effects that would harm the overall economy. On the other hand, critics claimed that the bailout plan gave birth to "zombie banks," institutions that could not survive without continual government support. They believed that until these unprofitable banks were allowed to fail, the credit crisis would continue.

Eventually the problems in the real estate market and banking industry spilled over into the entire economy. The Japanese economy entered a recession with the growth rate of real GDP falling from 6.2 percent in 1990 to only 1.0 percent in 1992. The government responded to the downturn using both monetary and fiscal policy. The Finance Ministry used monetary policy, lowering the discount rate in the middle of 1991. Between 1991 and 1993, the discount rate fell from 6 percent to 1.75 percent. By the end of the decade, the discount rate approached zero. Growth averaged 1.1 percent for the decade, and the 1990s ended with two years of decline in real GDP.

Japan also attempted to use fiscal policy to bolster the economy between 1992 and 1993 with a stimulus package equal to 6 percent of GDP. By 1995, the Japanese had spent nearly $2.1 trillion on public projects, mostly road and bridge construction, in an attempt to jump-start the economy. Many people were critical of the Japanese stimulus plan. Some argued that the government spent too much money, while others believed that the government stopped spending too soon. Some argued that the money was wasted on useless infrastructure projects and that they would have received more benefit if the money had been spent on education and social services. Others argued that the economy would have benefited more if the government had reduced taxes and allowed people to decide what to do with the money.

The economy started to rebound in 1994, with real GDP rising by 1.9 percent and 2.6 percent in 1995 and 1996, respectively. But this proved to be a false recovery. The economic stimulus plans were creating huge budget deficits. The deficits equaled 4 percent of real GDP for the decade of the 1990s. The Japanese government increased taxes to reduce the deficits and by 1997 real GDP growth was again at zero.

Activity 1, Continued
Japan's Lost Decade

Despite driving the discount rate down to 0.5 percent in 1995, Japan was still suffering from deflation. Between 1994 and 2009, prices declined each year, with the exception of 1997 when the GDP deflator rose by a modest 0.9 percent. Not only were low interest rates unsuccessful at defeating deflation, they did not have a significant impact on increasing the amount of borrowing taking place. Investment spending continued to lag, which helped keep the country in recession until 2003–2004, when Japan finally had back-to-back years of modest real GDP growth (rates well above 2 percent).

Late in 1997, Japan experienced the failure of some of its largest financial institutions. By the spring of 1998, the government began injecting an additional 1.8 trillion yen into more than 20 banks. In early 1999, the Finance Ministry lowered the discount rate to essentially zero.

Questions

A. What caused the speculative bubble in housing and stock prices?

B. What caused the bubble to burst?

C. What did the Japanese government do in the early 1990s to try to bring the economy out of the recession? Was it successful?

D. What controversies were there over the government response to the economic downturn?

E. Prices in Japan declined from 1994 through 2009, with the exception of 1997. If high inflation is a problem for an economy, is deflation good? Use the following two examples to help in answering this question.

Example 1. Assume you are a corn farmer. Corn is currently selling for $5 a bushel. You can produce a bushel of corn for $4.75. Therefore you plant your crops in April with the expectation of harvesting and selling your corn in August. But what if the country is suffering from

ACTIVITY 1, CONTINUED
JAPAN'S LOST DECADE

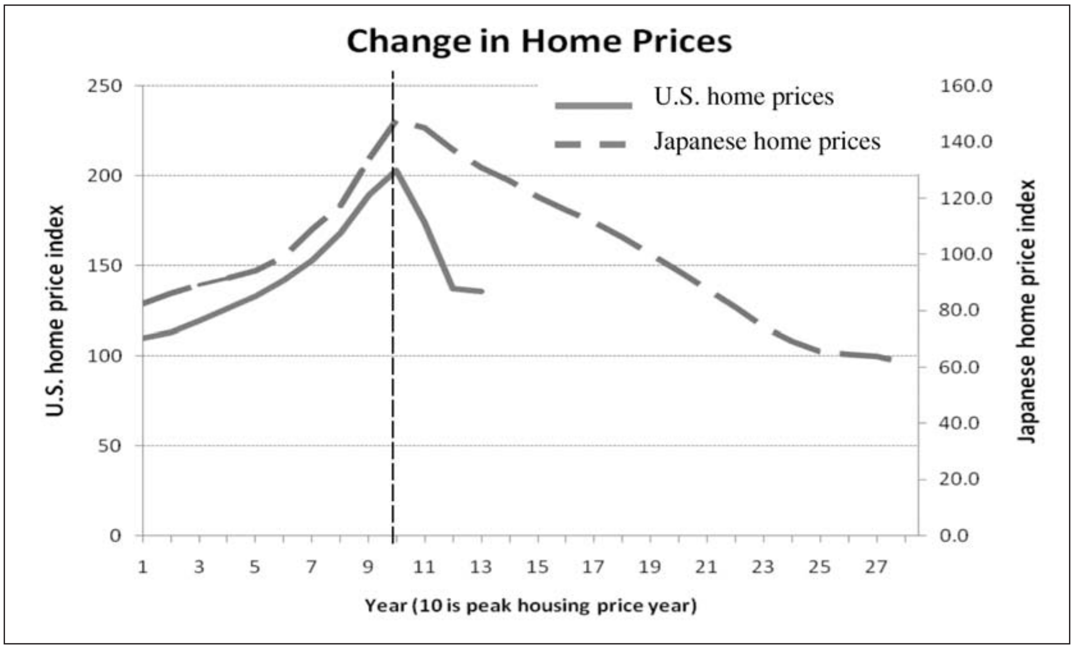
deflation? By the time you have harvested your crop, the selling price of corn is $4.60. Instead of making a profit of $0.25 a bushel, you have lost $0.15 a bushel. Now it is spring again, what will you do? The country is still in deflation, so that the costs of seed, fertilizer and workers have fallen and you estimate that you can produce a bushel of corn for only $4.30 a bushel. Will you plant corn this year?

Example 2. Assume you are in the market for a new automobile. Your current car still works fine, but you have been eyeing a new model. The car has not changed, but because the country is facing deflation, the price has fallen from $32,000 to $30,000. In addition, economists predict that the country will continue to be in a deflationary cycle for at least the next three years, with prices falling an average of 10 percent per year. Will you purchase the car this year?

ACTIVITY 2
COMPARING AND CONTRASTING THE JAPANESE AND U.S. FINANCIAL CRISES USING DATA

Below are a number of graphs comparing Japan and the United States. Each graph plots a given variable, such as unemployment or real GDP growth rates. The first data point for Japan is for the year 1982. The first data point for the United States is for 1997. This aligns the two data series such that the year housing prices peaked are at the same point on the horizontal or x axis. This is 1991 for Japan and 2006 for the United States.

Part 1. Change in Home Prices



Source: Data from Case-Shiller Home Price Index, www.irrationalexuberance.com, and Bank of Japan, www.boj.or.jp/en

1. The graph shows housing prices trended similarly in both Japan and the United States leading up to the peak.

A. Briefly describe the trends in housing prices in both countries after hitting the peak. In what ways are the trends similar? In what ways are the trends different?

B. Using this information, predict what you expect will happen to housing prices in the United States over the next five to 10 years.

C. Does the Japanese experience lead you to be optimistic or pessimistic about the future of housing prices in the U.S.?

Activity 2, Continued
Comparing and Contrasting the Japanese and U.S. Financial Crises Using Data

Part 2. Real GDP Growth Rates

Source: Data from the Bureau of Economic Analysis, U.S. Department of Commerce, www.bea.gov, and Bank of Japan, www.boj.or.jp/en

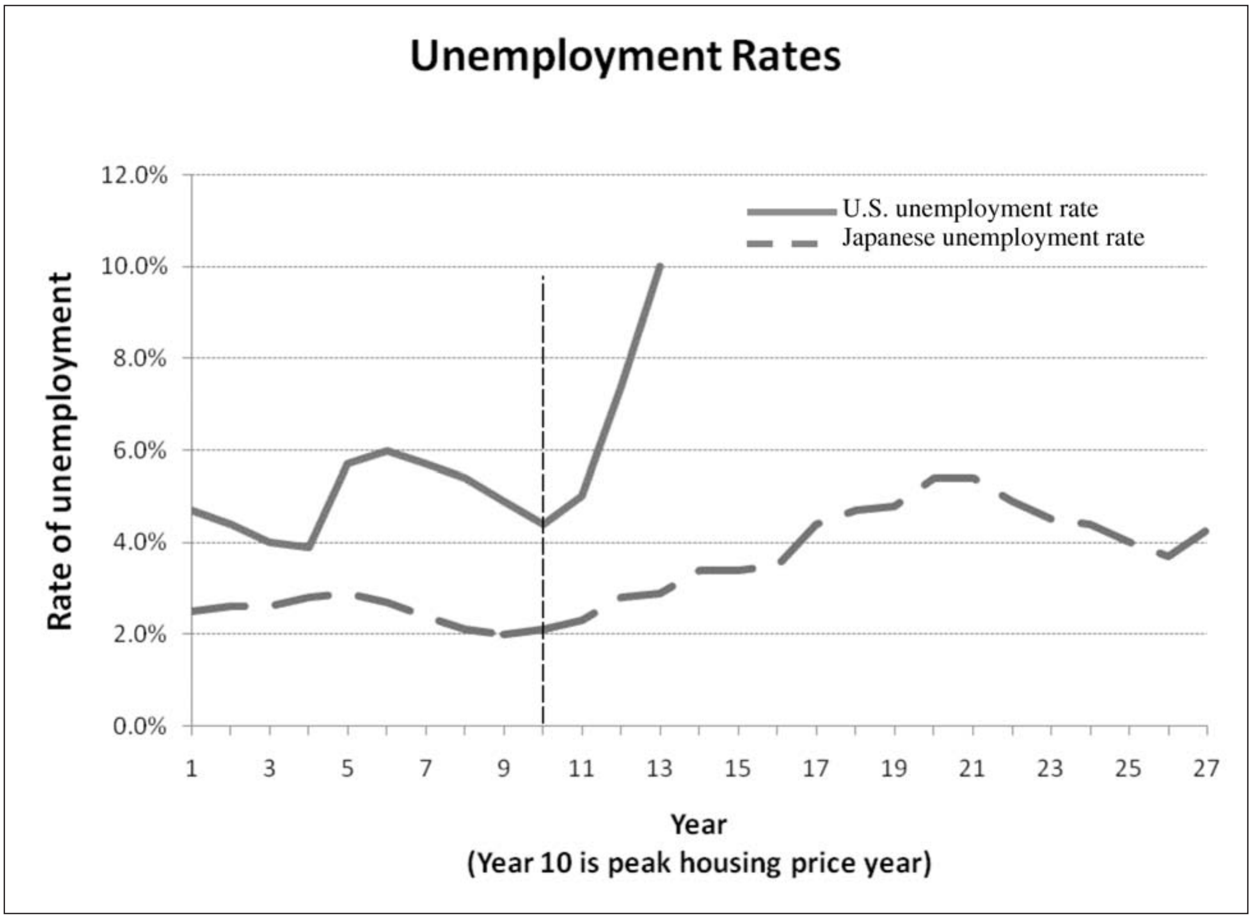
2. The graph shows the growth rate in real GDP for Japan and the United States.

A. Briefly describe the trend in the Japanese economy, as measured by the growth rate of real GDP, after the housing bubble burst.

B. One of the president's aides says that if the U.S. crisis follows the pattern of Japan, the worst is over and we should expect to see the economy grow again. How would you comment?

Activity 2, Continued
Comparing and Contrasting the Japanese and U.S. Financial Crises Using Data

Part 3. Unemployment rates



Source: Data from Bureau of Labor Statistics, U.S. Department of Labor, www.bls.gov, and Bank of Japan, www.boj.or.jp/en

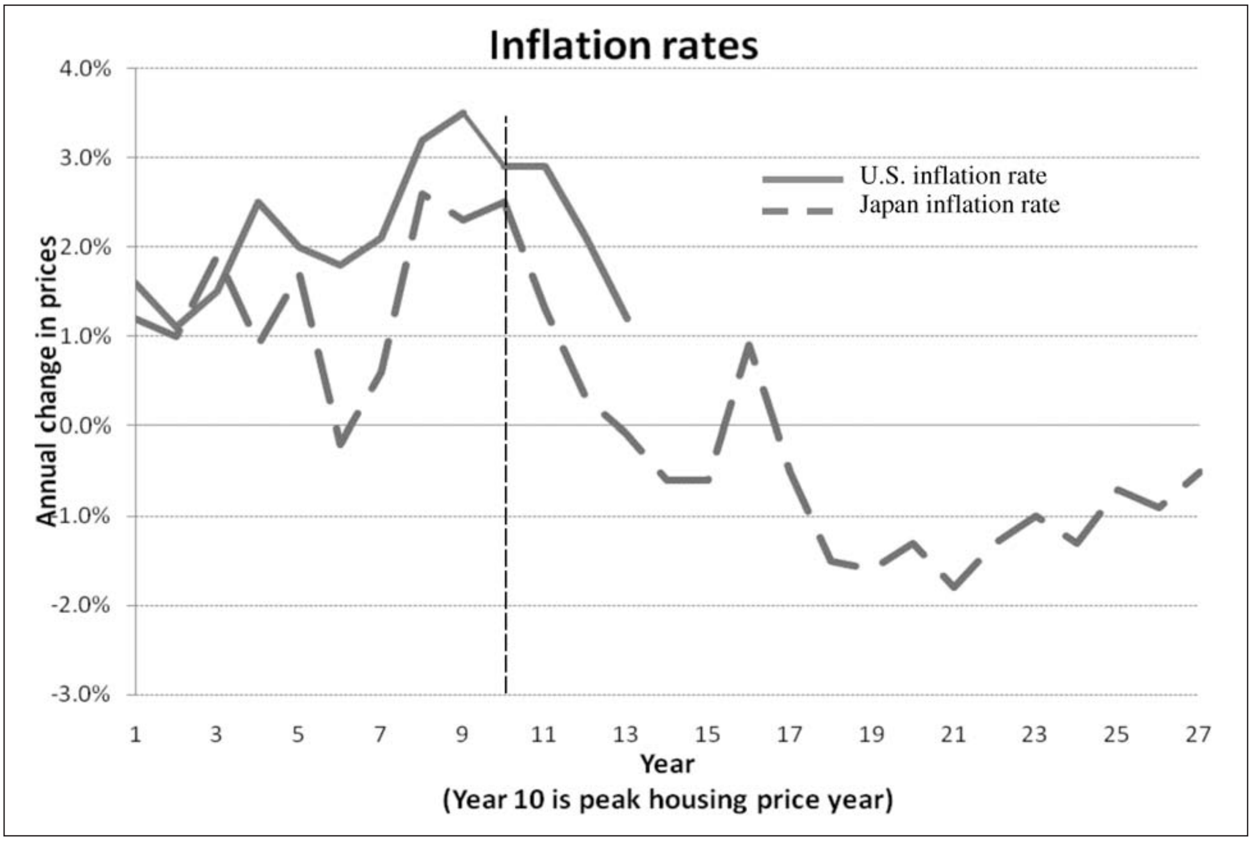
3. The graph shows the unemployment rate in Japan and the United States. The vertical line represents the year each country reached its real estate price peak.

A. Comment on the graph showing the unemployment rate in the two countries. How are the trends similar? How are they different?

B. Members of Congress are worried about unemployment in the long run. What does the Japanese comparison suggest for the United States? Do you think the United States needs to be concerned about unemployment?

ACTIVITY 2, CONTINUED
COMPARING AND CONTRASTING THE JAPANESE AND U.S. FINANCIAL CRISES USING DATA

Part 4. Inflation rates



Source: Data from Bureau of Labor Statistics, U.S. Department of Labor, www.bls.gov, and Bank of Japan, www.boj.or.jp/en

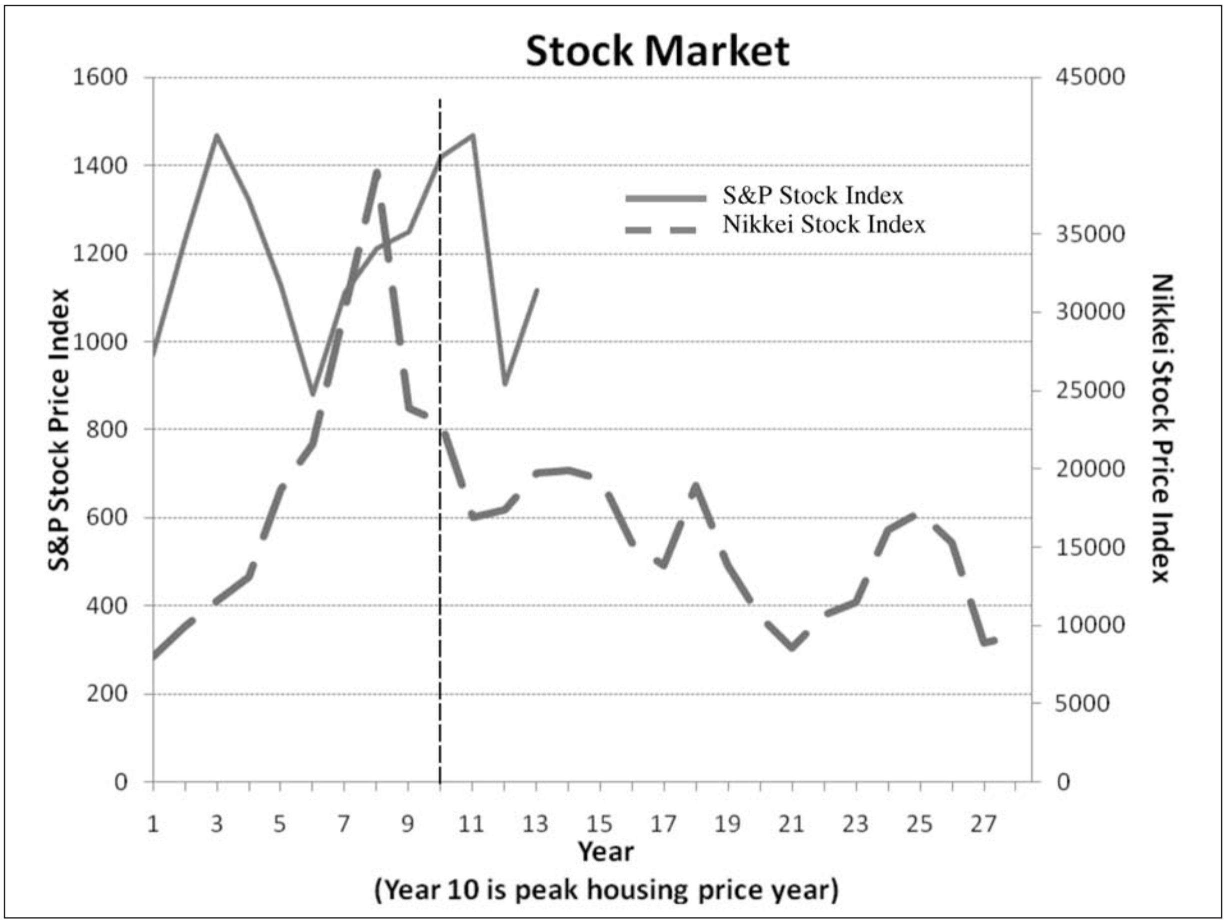
4. The graph shows the inflation rate in Japan and the United States as measured by changes in the GDP deflator.

A. Briefly describe the trend in inflation in Japan. Compare this with the inflation rate in the United States following the real estate market crash.

B. As an economic advisor to the president, why might the Japanese experience with inflation be a concern to you? Predict what you would expect to happen to real GDP in the United States if deflation were to take hold.

ACTIVITY 2, CONTINUED
COMPARING AND CONTRASTING THE JAPANESE AND U.S. FINANCIAL CRISES USING DATA

Part 5. Changes in the stock markets



Source: Data from the Board of Governors of the Federal Reserve System, www.federalreserve.gov, and Bank of Japan, www.boj.or.jp/en

5. The graph shows stock market prices for Japan and the United States.

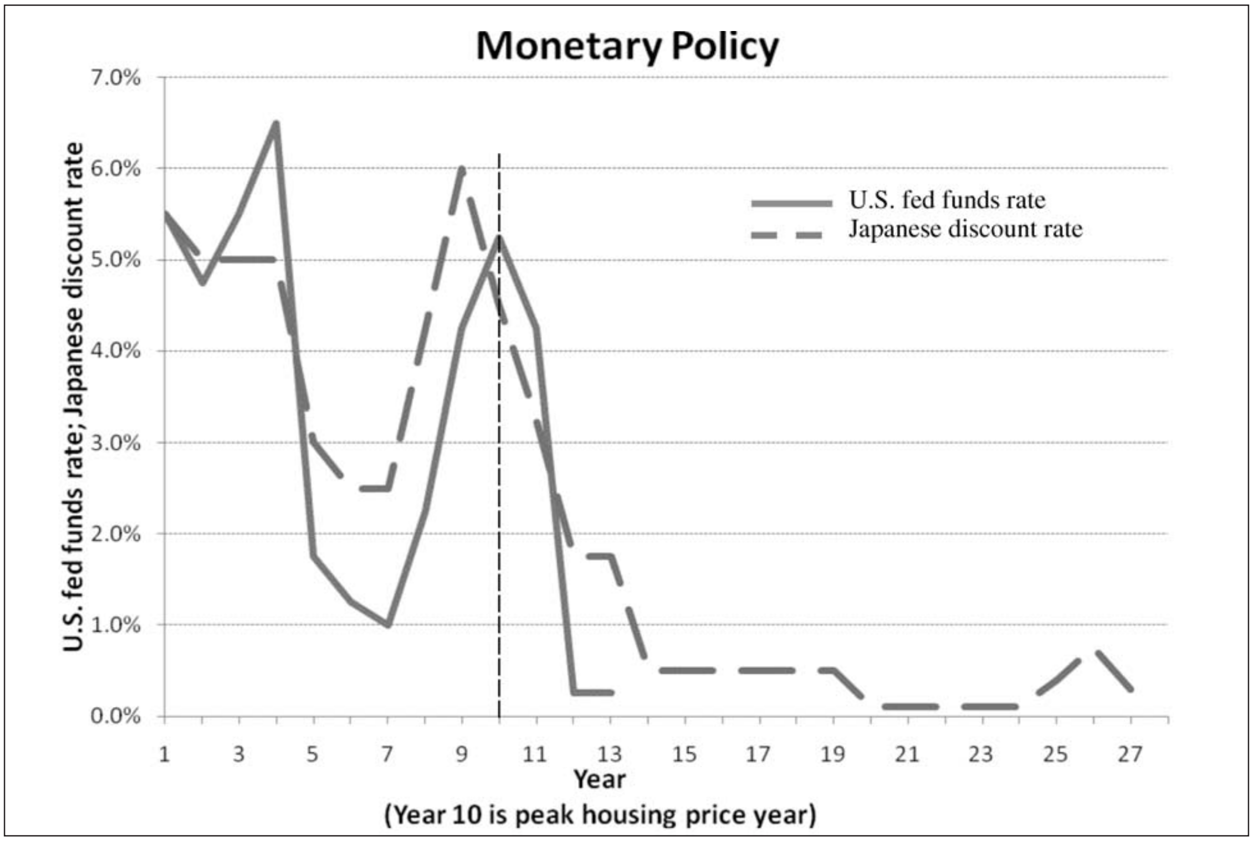
A. Comment on the trend in stock prices in the two countries prior to the peak in home prices.

B. Comment on the trend in stock prices in the two countries after the peak in home prices.

C. Does the recent increase in stock prices in the United States shown in the graph make you confident about the future of the economy?

ACTIVITY 2, CONTINUED
COMPARING AND CONTRASTING THE JAPANESE AND U.S. FINANCIAL CRISES USING DATA

Part 6. Monetary policy



Source: Data from the Board of Governors of the Federal Reserve System, www.federalreserve.gov, and Bank of Japan, www.boj.or.jp/en

6. The graph illustrates the monetary policies of Japan and the United States. Japan's discount rate and the U.S. federal funds rate are shown above.

A. Briefly describe the trends in monetary policy in the United States and Japan. How are the policy responses similar? How are they different?

B. What does the graph suggest about interest rates in the United States in the future?

Activity 3
Comparison of Government Interventions in Japan and United States Financial Crises

Japan			United States		
Date	Months from peak	Event	Date	Months from peak	Event
1991	-	Land prices reach peak	2006	-	Home prices reach peak
7/1991	9	First cut in discount rate	9/2007	7	First cut in fed funds rate
8/1992	22	First stimulus (additional stimulus packages in ’93, ’94, ’95, ’98 and ’99)	2/2008	12	Bush signs Economic Stimulus Act
11/1997	85	Four major financial institutions fail	9/2008	19	Government takes control of Fannie Mae and Freddie Mac. Lehman Brothers bankruptcy. AIG bailout
3/1998	89	Government injects 1.8 trillion yen (equal to $13.5 billion U.S. dollars; less than 0.5% of Japan’s GDP) into banks. (secondary injection in 3/99)	10/2008	20	Troubled Asset Relief Program (TARP) – purchase of stock in major banks $700 billion (equal to 70 trillion yen; almost 5 percent of U.S. GDP)
2/1999	100	Discount rate approaches zero	12/2008	22	Federal funds target rate of 0 to .25
			2/2009	24	$787 billion stimulus package

Source: Adapted from chart 1, www.boj.or.jp/en/type/press/koen07/ko0905a.htm

Which of the following statements can reasonably be supported by the information above? Explain why.

A. Both Japan and the United States employed monetary and fiscal policy in attempts to stabilize their economies.

B. The United States acted more quickly than Japan in trying to address their economic problems.

C. Banks were healthier during the financial crisis in Japan than in the United States.

D. Both Japan and the United States no longer have the ability to use traditional monetary policy as a means of improving the economy.

ACTIVITY 4
ADVISING THE PRESIDENT

The Council of Economic Advisors has spent a great deal of time learning about the similarities and differences between Japan's Lost Decade and the financial crisis of 2007-2009 in the United States. The president would like some recommendations from the Council concerning the following issues:

1. The U.S. government suffered a budget deficit of $1.4 trillion in 2009. This equaled 9.9 percent of GDP, the highest since WWII. Should the U.S. government start taking immediate action to reduce the deficit? Why?

2. What do you think is the biggest lesson that the United States can learn from Japan's Lost Decade?

