From Bubble Economy to Yen Bubble (1988–93)

It is quite possible to tell the story of the Japanese economy’s Lost Decade (1990s) as one of high speculative drama. Indeed, when recounted with skill, speculative panics and crashes make popular history, as J.K. Galbraith (1975) and C.P. Kindleberger (1977) found out in their respective volumes ‘The Great Crash 1929’ and ‘Manias, Panics and Crashes’. Surely, as the dust settles on the Lost Decade, an exciting historical narrative in the same spirit will emerge.

The story would start with the fantastic bubble in the equity and real estate markets during 1987–90, continue with the equity market crash of 1990 and the long-drawn-out collapse of real estate prices. But that would not be all. There is the bubble of the yen that at its peak in early 1995 was at a fantastic level of 80 against the US dollar. In turn, the incredible appreciation of the yen was a catalyst to the huge direct investment into Asia by Japanese enterprises, the so-called hollowing out of Japanese industry, and in turn a huge speculative bubble in the Asian host countries.

The inevitable bursting of the yen bubble was a key event leading up to the Asian crisis of summer 1997, as Japanese direct investment in East and South East Asia slowed and profits on exports from there (which had swollen due in part to the competitive advantage bestowed by the super-expensive yen) shrank. When the Asian bubble (summer 1997) burst the Japanese economy was whiplashed (1997–8) by a sharp decline in exports just at a time when its banking system was imploding under the weight of bad debts accumulated as a consequence of the real estate market slump and deep depression in the construction sector. The Japanese economy slid into its second major recession of the Lost Decade.

In this recession, monetary policy was largely ineffective, as the years of the super-strong yen (1992–5) had helped turn Japan into a land of falling prices. Nominal interest rates could not fall below zero, and so real interest rates could not reach the negative level suitable for an economy in depression. The best hope for economic revival came from the exchange rate – the continuing slide of the yen providing a stimulus to the export sector.
The next speculative shock came in autumn 1998, when there was a global liquidity crisis in the wake of Russia’s debt default. US hedge funds which had been major players in the so-called carry trade (borrowing yen to finance holdings of high interest foreign currency assets, mainly in US dollars) suddenly had to unwind their positions. The yen shot up almost 20 per cent in twenty-four hours – a bizarre event for the currency of the second largest economy in the world.

But then, amongst all the gloom, suddenly the skies brightened over the Japanese economy. The fantastic bubble developing in the worldwide market in hi-tech equities, led by the National Association of Securities Dealers Automated Quotations (NASDAQ), pulled the Tokyo equity market sharply higher, reflecting Japan’s role as a major manufacturer of hardware for the so-called new economy. Indeed, Tokyo equities could even have been described as being in a new bubble in 1999. Japanese exports also experienced rising demand from another main beneficiary of the new economy boom in the US – the Asian ex-tigers and ex-cubs. When the NASDAQ bubble burst in late 2000 the second Tokyo equity market bubble in a decade burst and the Japanese economy slid into a new downturn.

This last cycle of the Japanese economy – slump of late 1997 and 1998, recovery of 1999 and 2000, and downturn of 2001 – all occurred in the context of continuing price deflation, which could have been as much as −2 per cent p.a. if full account is taken of falling prices in the new economy. The severe deflation is the clue to one major missing ingredient in the attempt to discount Japan’s Lost Decade as a purely speculative epic. Substantial deflation is the result of extraordinary monetary conditions not necessarily in the present but at some time in the recent past. And for Japan the monetary origins of the deflation can readily be identified in the period 1990–5.

The importance of money in explaining the Lost Decade carries us back to a well-known point made by Milton Friedman in the 1960s. The starting point of Friedman’s comment is a quote from J.S. Mill, the famous Scottish political economist of the early nineteenth century: ‘There cannot be intrinsically a more insignificant thing, in the economy of society, than money. It is a machine for doing quickly and commodiously, what would be done, though less quickly and commodiously, without it; and like many other machines it only exerts a distinct and independent influence of its own when it gets out of order.’ Friedman then comments ‘But money has one feature that these other machines do not share. Because it is so pervasive, when it gets out of order it throws a monkey wrench into the operation of all the other machines. The Great Contraction (USA, 1929–33) is the most dramatic example, but not the only one.’

If the example had been to hand, Milton Friedman would doubtless have cited the Japanese Lost Decade of the 1990s. And in doing so he would