

What the Japanese bubble looked like

Economic note

30th June 2011

[It's interesting to think about why history repeats itself.](#)

One explanation highlights the difference between material and, say, moral knowledge. Material knowledge is self-evident. There are few, if any, examples of material knowledge going backwards. Generally, each generation of cars, planes, trains etc. are better than the previous generations. But in moral knowledge it's all too often the case that the mistakes of the past are repeated. Historic moral failures are not as self-evident as material failures. We think, somehow, that we can avoid the mistakes of the past even if we do the exact same thing.

This can be explained by our sense of freedom, which of course includes the freedom to make mistakes.

It's with this in mind that I would like to talk about the Japanese crash. We know a lot about the subsequent decline, the stagnation of growth, the price deflation and the growing belief in Japan that its best days are already passed. Mainly because these are all still with us. But the causes of the crisis were for me, at least, a little vague. That is until I read *The Bubble Economy* by Christopher Wood, currently a market strategist at CLSA.

It is a wonderful book. It fully illustrates the sheer craziness of the Japanese boom.

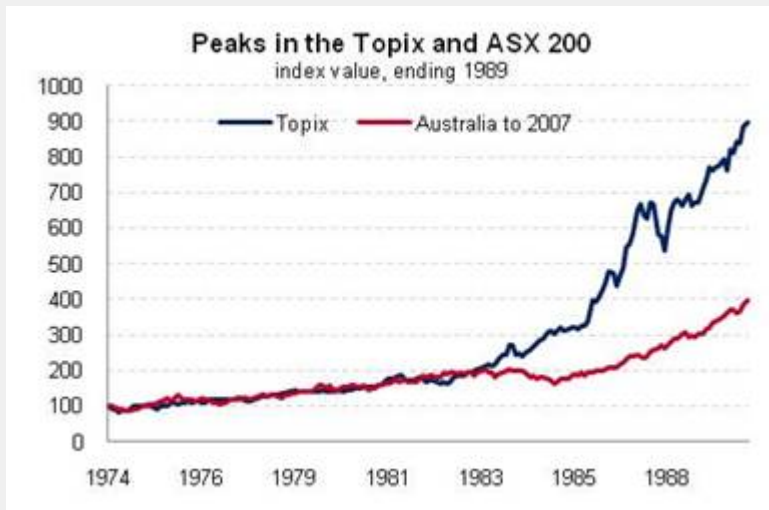
Its introduction is extraordinarily strange. Strange in a spooky, prescient way, that is. At least twice I went to the front of the book to check its publication date (1992). It is eerie just how similar it is to today, just swap Japan for China. Trade is important; the Americans were actively pressing the Japanese to appreciate so as to support their manufacturing industry, particularly cars. The US was again in a large credit related slump. Japan's role in the world was unclear; they wanted more power but received no support. Japan was an active offshore buyer of assets.

The banking industry was at the heart of the Japanese collapse.

At the core of the problem in Japan was a problem that, one day, China too will have to face – the end of the mandated spread between deposit rates (there's a ceiling) and lending rates (there's a floor). This was the great source of profitability and security in the Japanese model, as it is in China today. In Japan de-regulation began in 1985 and was due to be completed by April 1991 when all deposits over Y500k had to receive money market rates. Japanese banks failed to change their balance sheet and business model until the change actually occurred. The result was disastrous.

Bank profitability, prior to the change, was based on the sale of stocks. To March 1989, 42% of all bank profits came from the sale of stocks. There were obviously a lot of problems here. Banks might have been selling stocks at massive profits – one example was Nippon Steel at Y50 in the 1950s and at Y1000 or so in the 1950s. But by then buying the stocks back they made cash losses; a combination of capital gains taxes and the higher prices they were likely to have paid. Their capital base was only expanding because share prices were rising.

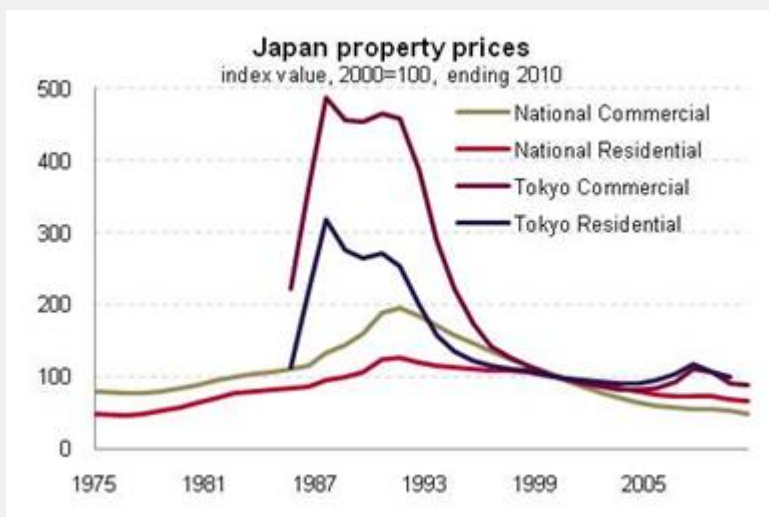
Prices weren't just going up, they were sky-rocketing. It's useful to look at just how amazing the Japanese bubble was. There have been bigger bubbles; the rise in the Nasdaq in the tech boom far outstrips the rise in the Topix. But, the Nasdaq doesn't represent an entire economy. For Australian readers I have compared to the ASX200 in the 16 years prior to the 2007 peak with the Topix peak.



Source: Bloomberg

Valuations are probably an even better way of explaining the peak. NTT, Japan's state owned telco, was sold to private investors at a P/E ratio of 200. Two or three years after the crash bank stocks were still trading at P/E ratios in the mid-60s. Another, extraordinary, feature of the stock market boom was the propensity of brokerages to reimburse the losses of their big clients. For the large institutional investors it was heads I win, tails you lose, just as long as there were still buyers of stock.

Property was equally part of the equation with banks and other investors also playing a part in an extraordinary boom. In the eighties property prices benefited from the Japanese "love of property" (I guess every national culture loves property when it appreciates) and an extraordinary set of capital gains tax laws. Property held for less than two years had an effective tax rate on capital gains of over 90% while even property held longer than five years had an effective tax rate of 50%. With a limited incentive to sell, even as genuine demand forced up prices, a very illiquid market led to enormous appreciation on the way up and spectacular falls on the way down. The subsequent bust saw prices falling 72% in Tokyo residential and 83% in commercial. In Ginza prices fell to around 1% of their peak value.



Source: Bloomberg

There were even bubbles in golf club membership.

Japanese investment behaviour offshore was as harmful. Japanese investors bought hotels, golf courses and office buildings and other trophy assets all over the world. They were prepared to pay astronomical prices but often had little understanding of the market. US bankers described Japanese bank offices in the US as being staffed with Japanese bankers from head office on short secondments and fourth rate Americans. A good example of this failure to recognise the market was the Japanese buying spree in L.A. where Japanese banks operated under the mistaken impression that in some way L.A.'s CBD was an under-valued Manhattan. Is this the best example ever of a value trap?

And when this period of extreme over-valuation was over, in 1991, Japanese banks were left with Y3 trillion of reserves to cover over-valued loan books of Y450 trillion. The subsequent collapse of the economy was inevitable.

I am sure there are many more egregious stories of the profligacy of Japan's boom, and I am happy to hear them. As to the specific consequences and reflections on China, that is for another time.

More generally, can we overcome our innate flaws so as to avoid a similar crash. I doubt it and I certainly don't think any institution will ever be entirely successful. Ultimately institutions, too, must deal with the freedom to make mistakes which means people will find ways to go around, through or over institutions that attempt to stop us from making mistakes.

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