

# Technical Notes



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## Why the U.S. is not Headed for A Japanese-Style Recession

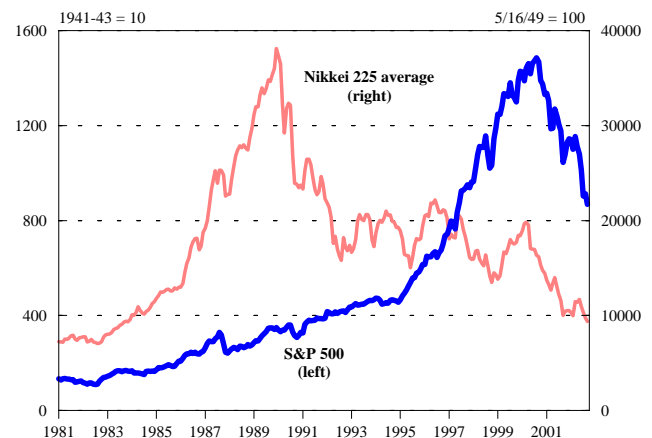
Some have argued that the economic shock suffered by the U.S. on September 11 sharply raises the risks that the U.S. economy is headed for a Japanese-style recession. Japanese GDP has risen only about 1% annually since 1991. If by “sharply” they mean the odds have increased from 1 in 100 to 3 in 100, then maybe so. While there is at least one potentially important similarity — the bursting of a stock-market bubble — there are several significant differences between the U.S. economy of today and the Japanese economy of the early 1990s that suggest the risk of a prolonged recession here is very small.

Those who argue the U.S. could be headed for a Japanese-style meltdown point to similarity between the bursting of the stock-market bubble here in 2000 and in Japan in 1990. As shown at right, the previous increases in stock prices and the initial declines are broadly alike, although slightly less sharp in the U.S. than in Japan. More significant are the four main areas of difference between the Japanese and U.S. economies: 1) health of their banking systems, 2) reliance on bank lending for business financing, 3) the behavior of real estate values, and 4) the aggressiveness of fiscal and monetary policy responses.

In Japan, the bursting of the stock-market bubble greatly weakened the health of the banking system and made it difficult for the economy to shrug off the initial weakness and return to at least average long-run growth. Unlike U.S. banks, Japanese banks typically hold large equity positions in non-banking corporations. In 1989, equity holdings of Japanese banks amounted to roughly 6% of their assets. In contrast, U.S. banks hold almost no corporate equities. Last year, for example, U.S.-chartered banks held only about \$25 billion in corporate equities (including mutual fund shares), only about 0.5% of their financial assets. As a result, the direct impact on the balance sheets of U.S. banks of last year’s decline in stock prices was imperceptible. After the 1993 Basle accords, which imposed risk-based capital requirements, Japanese banks had a greater incentive to respond to the decline in the value of their equity holdings by increasing the share of assets, such as government bonds, that received a zero risk weighting and reducing the share of riskier assets, such as loans. This typically required a curtailment of lending activity.

Compounding Japanese banks’ greater reluctance to lend in the wake of plunging stock prices was the high degree of reliance in Japan on bank financing. In 1989, bank loans accounted for 87% of all non-financial corporate credit-market debt. In contrast, today in the U.S., bank loans

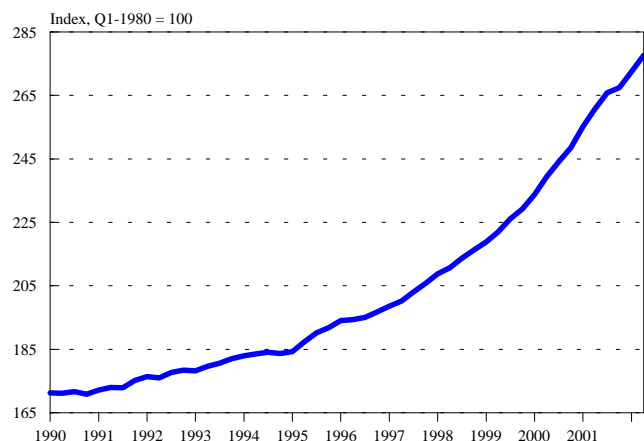
### U.S. & Japan: Bursting of the Equity Bubble



account for less than 20% of nonfarm, non-financial, credit-market borrowing (Source: Flow of Funds, table B.102). Thus, even if U.S. banks in the aggregate reduced lending because of rising business climate uncertainty, it would have a proportionally smaller impact on the ability of U.S. firms to borrow than would be the case in Japan. Moreover, because of well developed credit markets in the U.S., a decline in bank lending would likely lead to increased use of non-bank credit, e.g. commercial paper. That is, total credit issuance would shrink by less than the decline in bank lending because of other channels of financing. Given relatively under-developed credit markets in Japan, the opportunity for increased non-bank financing to replace reductions in bank financing is much smaller.

Japan also suffered the rise and bursting of a real estate bubble. From mid-1986 to mid-1990, residential land prices in Japan’s six largest cities (adjusted for inflation) rose by 150%, but from mid-1990 to mid-1992 these prices

### House Price Index



fell by 22%. (Note that the absolute decline was 55% of the level in 1986.) No such bubble has developed in the U.S. The chart shows an index of existing home prices constructed by the Office of Federal Housing Enterprise Oversight (OFHEO). This index, referred to as the House Price Index, or HPI, is constructed from price changes for repeat sales of existing homes, so it is unaffected by changes in the mix of quality, size, or location of homes. The HPI rose 5.6% in 1999 and 8.4% in 2000. In the last eight quarters ending in the second quarter of this year, the HPI also rose 8.4%, 4.8 percentage points faster than (CPI) inflation over the same period. After adjusting for inflation, the HPI rose only 19.1% from the end of 1996 to the second quarter of this year, in contrast to the 150% rise in real residential real estate prices in Japan in the late 1980s. The rate of increase in U.S. house prices would hardly be considered a bubble. To the extent excessive valuations have crept into the residential housing market, they have been fairly localized. Therefore, the risk in the U.S. of a simultaneous collapse of housing and stock prices is small.

a negative wealth effect associated with declining stock prices.

Japanese policymakers initially responded cautiously to the bursting of the stock-market and real-estate bubbles. The Bank of Japan's discount rate was increased between December 1989 and late August 1990 by 75 basis points, even though the Nikkei 225 index fell more than 46% over roughly the same period. It was not until July of 1991 that the Bank of Japan embarked on a succession of aggressive easing moves. The effectiveness of expansionary monetary policy was blunted in Japan because of significant reliance on bank lending, and problems created for banks when asset prices fell. Banks tended to absorb new reserves made available by the Bank of Japan's actions, but remained reluctant to use those reserves to make new loans. A comprehensive fiscal stimulus package was not offered by the Japanese government until late 1992, more than two years following the bursting of asset-price bubbles. (IMF WP/93/85-EA <#126> Japanese Banks and the Asset Price 'Bubble' by Steven M. Fries.)

In contrast, both monetary and fiscal policy measures were applied quickly and forcefully in the U.S., even before September 11. From January to December of 2001, the Federal Reserve lowered the target federal funds rate from 6.0% to 1.75% in response to an abrupt slowdown in GDP growth. Personal tax reductions at the federal level were passed, and "rebate" checks totaling roughly \$40 billion were mailed to consumers in the third quarter of this year. It is often asserted that this tax cut seems not to have had much effect; we do not agree with this assertion. MA had expected the tax reduction to prevent what would otherwise have been a sharp decline in growth of personal consumption expenditures, rather than spark a spending boom. The tax rebates arrived right as the earlier decline in stock values was having its maximum negative effect on consumer spending. In this sense, the tax cut and the speeding of checks to taxpayers "filled in a hole" caused by