A Reprint from *Tierra Grande*

LAND OF THE SETTING SUN

BY MARK G. DOTZOUR

Japan was the economic wonder of the world in the 1970s and 1980s. Profits were pouring in. Interest rates were low, and bank lending was aggressive. The Japanese stock market peaked in 1989 and then collapsed. Bank losses were huge. The real estate market did the same thing. Real estate all over the country was "underwater." It sounds eerily similar to what the United States has been dealing with in the past four years.

Why should we care about Japan's experience? Because we don't want to repeat it.

Twenty-two years after the Nikkei Index peaked, it is still down 78 percent. Commercial real estate dropped in value for more than a decade, and prices haven't recovered. The Japanese government runs deficits every year, and Japan is one of the most heavily indebted nations on earth. Interest rates are extremely low, but economic growth is not occurring.

Beginning of Boom

The Japanese economic expansion began as a result of cheap currency, low interest rates and aggressive bank lending. The Japanese yen was introduced to world currency markets in 1871, when it was worth one dollar. After World War II, the official exchange rate was 360 yen to the dollar.

When a foreign country makes its currency artificially cheap, it is virtually

ARTIFICIALLY CHEAP *currency in the 1980s allowed Japanese automakers to produce cars superior to American-made ones and sell them for the same price. Hundreds of thousands were exported to the United States.*

impossible for American companies to compete. So American manufacturing plants close and relocate to other countries. Fast-forward to the 1980s, and you can see how Japan could offer superior quality cars compared with American-made cars for the same price.

Some refer to the 1980s as the "Japanese Miracle." Japanese banks paid low interest rates on savings accounts and loaned money to major corporations at low rates as well. The combination of cheap currency and aggressive bank lending at low rates created plenty of fuel for economic growth. Consumer debt increased from nine trillion yen in 1979 to 67 trillion yen in March 1991.

At the peak of the frenzy, Japanese banks conducted business as though real estate prices would never fall. With real estate as collateral, it didn't matter whether a business or a building generated enough cash flow to support the loan. If the loan went bad, they could always sell the property and repay the loan.

The United States, Germany and the United Kingdom went along with this Japanese scenario for many years. By 1985, the flow of wealth out of those countries to Japan became alarming. U.S. Treasury Secretary Donald Regan went to Tokyo in 1984 and famously pounded his fist on a table to demand that Japan revalue their currency. Partially in response to this, Japan started building factories in the United States in areas where labor unions were scarce.

In 1986, mounting anger in the United Kingdom and the United States led to open threats of retaliation. The Senate prepared a bill involving mandatory retaliation against trading partners with large trade surpluses.

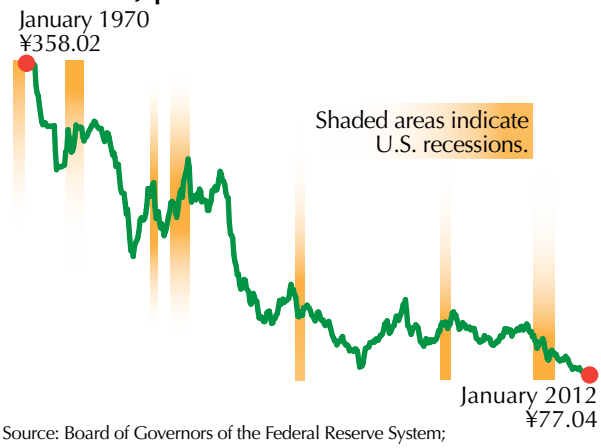
In 1985 and 1986, four of six U.S. producers of 256k dynamic random access memory chips stopped producing them for commercial sales because Japanese competitors were dumping the chips into the market. The U.S. semiconductor industry lost more than $1 billion in 1986, and layoffs resulted in the loss of 60,000 jobs from 1984 to 1986.

Americans became increasingly concerned about losing wealth to Japan. Amidst this concern, a meeting of finance ministers from Germany, the United Kingdom, the United States and Japan convened at the Plaza Hotel in New York City in September 1985. The goal of the meeting was to ask Japan to stop keeping its currency artificially low. The result of this meeting was called the Plaza Accord. This was a watershed moment in economic history for America. But it took some time for the results of this meeting to be felt in the broader global economy.

In March 1987, President Reagan imposed 100 percent tariffs on selected Japanese electronic products. On July 1, nine congressmen assembled on the lawn of the Capitol and smashed a Toshiba television with sledgehammers. The same day, the Senate overwhelmingly approved the Omnibus Trade Bill requiring import penalties that prohibited Toshiba from exporting products to the United States for two to five years.

The yen appreciated against the dollar by 40 percent in 1985 and continued to appreciate into 1987. This rapid appreciation made Japanese exports more expensive and resulted in a contraction in Japanese manufacturing output. From its trough of 263 yen to the dollar in February 1985, the yen appreciated to 129 per dollar in November 1987 (Figure 1). This was the beginning of the end of the Japanese Miracle. It was also the beginning of a bubble of massive proportions in the Japanese stock market and real estate market.

Figure 1. Foreign Exchange Rate
Japanese Yen to One U.S. Dollar



Source: Board of Governors of the Federal Reserve System; 2011 research.stlouisfed.org

WHEN THE YEN ROSE *against the dollar, the Japanese bought enormous amounts of U.S. real estate. Among the more iconic purchases was the Pebble Beach golf course on the California coast.*

Japan went on a foreign buying spree in 1986. It bought U.S. Treasuries, stocks and real estate as well as corporations all over the globe. Everything on earth looked like a bargain.

Large office buildings in New York and Los Angeles and hotels in Hawaii beefed up Japanese portfolios. In 1986, Shuwa Investment Corporation purchased Arco Plaza in Los Angeles for $620 million, the biggest all-cash transaction in U.S. history at that time. Mitsui Real Estate Development purchased the Exxon building in Rockefeller Center for $610 million. Cosmo World purchased Pebble Beach, planning to make it a private club and sell memberships. Japanese car companies built new factories in America, creating thousands of jobs.

Back in Japan, the stock market was on fire. The Nikkei 225 rose from 11,500 in January 1985 to 38,900 in 1989. The Nikkei became the largest market in the world in terms of capitalization of listed companies. One stock, NTT, went public with a price-earnings ratio of 250.

Japanese banks were rolling in the profits from their stock holdings. They were allowed to count 45 percent of their stock market gains as capital, so a bank's capital adequacy became dependent on stock market prices. At one point, the five largest banks in the world were Japanese.

The banks aggressively made real estate loans. Underwriting and risk analysis was not a high priority at the time. The assumption was that real estate always goes up in value.

The Japanese real estate market, like its stock market, had become a bubble. By 1990, it had a theoretical value of two quadrillion yen, four times the value of all real estate in America. The estimated value of real estate in Tokyo alone was greater than the value of all real estate in America. New construction expanded dramatically. Condominium prices in Tokyo rose to more than ten times the average wage-earner's salary. Land prices in central Tokyo increased by 75 percent in 1986.

Collapse of the Miracle

In May 1989, the Japanese central bank started raising interest rates to slow the frothy economy. The discount rate increased from 2.5 percent to 6 percent by the end of 1990. From 1988 to 1991, Japan's gross domestic product (GDP) grew by an average of 4.9 percent annually. But from 1992 to 1997, annual real growth of GDP in Japan averaged only 1.4 percent.

The Nikkei stock index hit its all-time high in December 1989, with intraday trading at 38,957 (Figure 2). By October 1990, the Nikkei had lost 48 percent of its value, and 300 trillion yen of wealth was gone. By 1993, the market had fallen over 61 percent to 15,000. The decline finally hit bottom in March 2009, when the index traded at 7,054. The Japanese stock market had declined 82 percent over a 20-year period.

After the stock market crash, most people didn't think real estate prices would fall. Japanese central bankers implemented credit controls on real estate loans to slow the growth of the bubble. Little new credit was flowing into real estate.

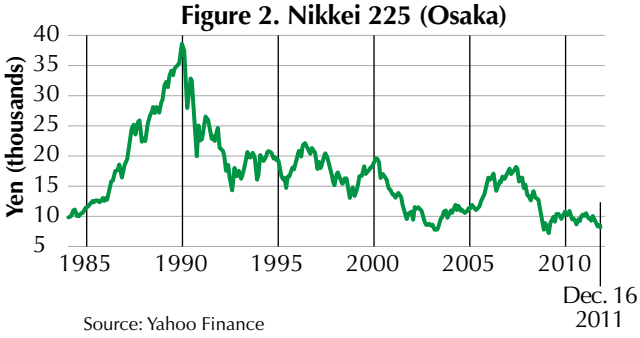
The market was virtually frozen. The central bank committed to producing an "orderly decline" in land prices. Prices fell for nearly 15 years before finally hitting the trough in 2007.

By late 1991, bid prices for real estate in Tokyo and Osaka were estimated to be 30 to 50 percent below the "official" prices set by the National Land Agency. Transaction volume plummeted, so it was impossible to know what the real value of real estate was.

Prices for detached houses in Tokyo had declined by 37 percent. Sellers refused to sell and take a loss. The capital gains tax on property was increased to 90 percent for properties held less than two years and 75 percent for those held two to five years. This discouraged owners from selling.

Japanese banks were not required to disclose nonperforming loans, and they could report income from a troubled loan for a year after they stopped receiving

Figure 2. Nikkei 225 (Osaka)



Source: Yahoo Finance

payments. When the real estate bubble burst, bank loan collateral vaporized.

The banking system was virtually insolvent overnight. Banks had already taken severe losses on stocks they owned when the market crashed. The combination of massive losses in stock portfolios and real estate loans overwhelmed the banking system.

The label "zombie bank" was used to describe banks that were insolvent but still alive, unable to make new loans. The country was teeming with zombie banks and zombie companies. The 1990s became known as the "lost decade." Banks hoped they could hold on to their nonperforming real estate loans throughout the downturn without having to sell the collateral in a depressed real estate market.

In April 1992, Japan's finance ministry tried to raise confidence in the banking system by explaining that bad debts at 24 financial institutions totaled eight trillion yen, an amount the government considered manageable and much lower than had been reported. Shortly after, a confidential central bank study estimated the losses at 29 trillion yen. After more disclosures, those losses ballooned to 56 trillion yen.

In 1997, a series of Japanese banks failed, further eroding confidence in the system. The government injected $1.8 trillion yen into the largest banks, but that failed to resolve the crisis.

Finally, in 2002, Heizo Takanaka became minister of state for financial services and created the "Takanaka Plan," which audited banks and forced them to write off hundreds of billions of yen in bad loans. By 2005, Japanese banks had written off roughly 96 trillion yen in loans.

Today, the Japanese economy is still moribund, and the stock market remains 78 percent below the peak.

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THE TAKEAWAY

When Japan's stock market crashed and a real estate bubble collapsed in the early 1990s, the country adopted a policy of "extend and pretend." The results serve as a cautionary tale for the United States, which is in a similar situation now.

JAPANESE LESSONS

一

When a country keeps its currency too cheap, it consumes jobs and wealth from its trading partners. Japan experienced this in the 1970s and 1980s. China is doing the same today.

二

Japan bought U.S. Treasury bonds to manipulate its currency. China is doing the same today. Japan couldn't sell its U.S. bonds and keep currency low. China can't either (see "China's Crisis, America's Hope?" p. 2) .

三

When a central bank keeps interest rates too low for a long time, as Japan's central bank did, speculative bubbles occur and subsequently burst. The United States found that out first hand with the 2007 bubble in residential and commercial real estate. As the Fed keeps interest rates at zero, more bubbles are likely to form.

四

When Japan tightened credit on real estate, the bubble burst. In America, real estate credit has been and is still tight and declining.

五

Japanese banks refused to recognize the colossal losses they had incurred in real estate loans. This led to a decline in real estate prices that lasted for more than a decade. The United States adopted an "extend and pretend" mentality to avoid recognizing losses, too.

六

The stronger yen made Japanese manufacturers less competitive in the global economy, so they purchased land and built factories in America, employing American workers.

七

After 20 years of stock market declines and declining real estate values, the Japanese are reluctant to buy stocks, so they buy government bonds with 1 percent interest rates. Americans, too, are losing confidence in the U.S. stock market.

八

While the stock market crash happened in 1989 and the real estate bubble didn't burst until 1991, the Japanese economy continued to expand until 1996, when it finally contracted into recession. This illustrates how even the strongest economies cannot overcome a prolonged banking crisis.

九

When the Japanese yen started to appreciate, the Japanese bought lots of real estate in America at extremely high prices. As Chinese currency appreciates in coming years, the Chinese are likely to do the same.

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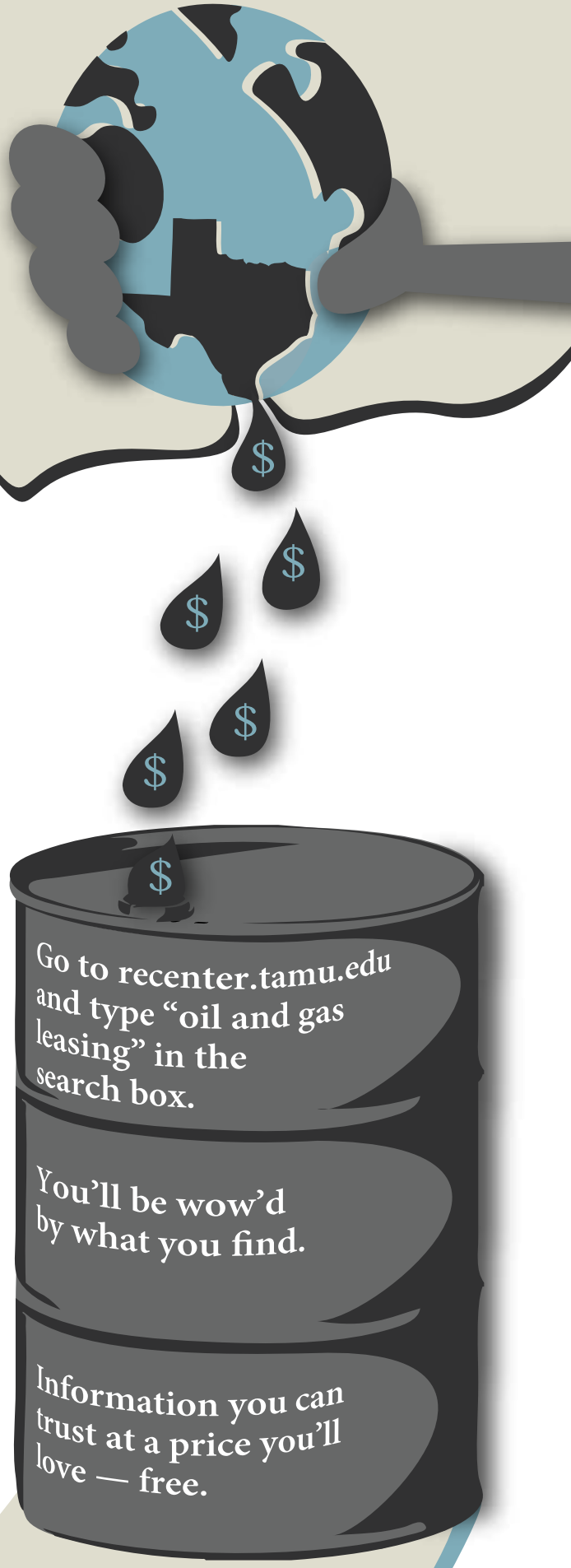
Tierra Grande (ISSN 1070-0234) is published quarterly by the Real Estate Center at Texas A&M University, College Station, Texas 77843-2115. Subscriptions are free to Texas real estate licensees. Other subscribers, $20 per year. Views expressed are those of the authors and do not imply endorsement by the Real Estate Center, Mays Business School or Texas A&M University. The Texas A&M University System serves people of all ages, regardless of socioeconomic level, race, color, sex, religion, disability or national origin. Photography/Illustrations: Real Estate Center files, pp. 1–2; Robert Beals II, p. 3.

The oil and gas reviews are in!



Colossal!*

*Amount of oil and natural gas drilling in Texas.

Immense!**

**Amount of knowledge landowners need to negotiate an oil and gas lease.

Monumental!***

***Amount of oil and gas leasing information available on the Center's website.

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