

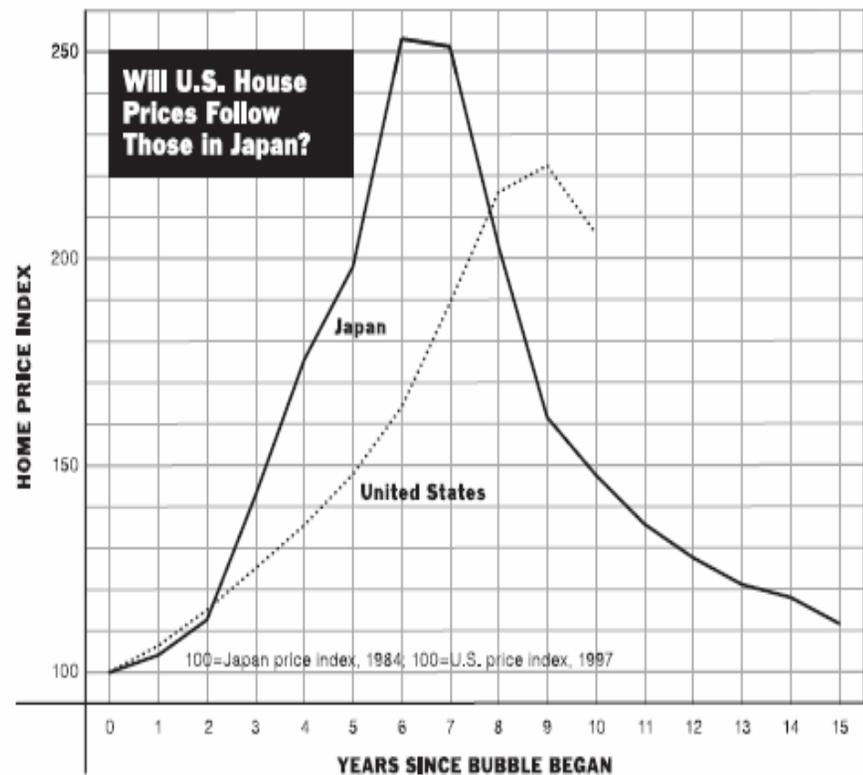
# Parallels in Financial Crises: *Lessons from the Japanese Experience*



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# What Just Happened?

- First: Big rise in home prices
- Then: Modest fall in home prices
- Now and Future: Some people walking away from “underwater” mortgages
- **Conclusion: Somebody won't get paid**



Source: Statistics Bureau Japan, S&P/Case-Shiller Home Price Index

Source: Alex Tabarrok (GMU), "Home Sweet Investment," *New York Times*, March 18, 2008.

# Ours is not an “unprecedented crisis.”

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- Japanese real estate bubble burst in 1992.
- Japanese government responded with massive bailouts and regulatory interventions:
  - Bought bad loans
  - Bought shares in troubled banks
  - Rewrote accounting rules to help banks
  - Unwilling to let bad banks fail
    - ***Bad for “confidence”***
- Sound familiar?
- *Net result: “Lost Decade” of 1% average growth, far below old 4% average.*

# How did the bursting bubble create a “lost decade” for Japan?

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- Japanese government created zombies

- [Zombie Japan Bank] gets 1400 hits on Google Scholar

- **Zombies:** *Banks or businesses with huge debts and low productivity, kept alive through government support.*

- Zombie banks “kept hope alive” by renewing old loans, creating zombie firms:

- *Why tell stockholders you made bad loans?*

# The importance of killing zombies (eventually)

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## □ **Problem:**

- Job destruction is a big part of economic progress
- In average U.S. month, 2M jobs are destroyed and 2.1M jobs created: Lots of **churn**
- Net rise averaging 100K/mo: What we get excited about

## □ 60% of long-run growth due to **churn**

- New firms: 25% of growth in living standards
- More output at better firms: 35% of such growth

Source: Haltiwanger and Davis (1999), "Gross Job Flows"

## □ If zombies persist, too many people work at low-productivity businesses: Lower living standards

- But no one wants to issue pink slips....

# Why it's hard to kill zombies

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- The right time to be the bad cop: **Later**
- Especially when innocent bystanders will be hurt
- **Especially** right before an election
- Finn Kydland and Ed Prescott's Nobel-winning story: **Time Consistency** of delay
- **Lesson: if Congress could sign a binding contract to "get tough later" it would—but Congress can't sign binding contracts...**

# Will the U.S. create zombies?

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- Pro-zombie: Big decline in U.S. stocks
  - Markets foresee future imperfectly
  - Perhaps they foresee a lot of zombies
- One possible reason for massive fall:
  - Bryan Caplan's (2003) "Idea Trap"*
  - Bad ideas flourish in bad economic times
  - Result: More bad economic times
  - Examples
    - FDR's pro-cartel policy (Cole and Ohanian (2004))
    - Peron in Argentina (formerly 4<sup>th</sup> richest country)
    - Obviously, Hitler.

# Regulations: An “Idea Trap?”

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- Each additional page in CFR (Code of Federal Regulations) costs U.S. economy \$9.2 million in lost output, on average.

- Rough estimate:

*Average American would be 10% richer*

*if CFR stayed same length since 1955.*

Dawson and Seater (2005) “Regulation and the Macroeconomy.”

- *In line with estimates by other scholars.*
- *So if government is efficient, non-economic benefits will average more than \$9.2M per page...*

# What eventually happened in Japan?

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- ❑ Leading economists advised Japanese government (e.g., Hoshi and Kashyap)
- ❑ Advice ignored for years
- ❑ *No one wants to give pink slips...*
- ❑ Prime Minister Koizumi (2001-2006) implemented some reforms at great political cost
- ❑ Better growth since 2001



Prime Minister Koizumi



# Will we do better?

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- That's up to your bosses...