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The Influence of the Japanese Real Estate Bubble Economy on the Stability of the Financial System

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Abstract: The financial stability is critical to sustaining economic growth and minimising the financial risks and losses. As a pillar industry of the national economy, the real estate sector has a significant place in economic activities. Japan experienced a real estate boom last century but then witnessed a real estate bubble economy in the 1980s. The bubble economy adversely affected Japanese financial stability and caused a financial crisis in Japan. Based on the literature review method, this paper collects and collates the previous literature on this topic. This essay firstly talked about the formation and burst of Japanese real estate bubble economy and then discussed the impacts of it on the financial stability. Result and conclusion: The study finds that, during the bubble period, the development of the real estate bubble economy adversely affected the financial systematic stability. Excessive credit expansion resulted in a large proportion of nonperforming mortgage loans and restricted the bank liquidity. Rising asset price increased the gap between the market value and fundamental value of the property and the bank witnessed a financial loss. These findings provide references and suggestions for maintaining the stability of financial system when the real estate bubble crisis erupt in the future. This enhances the ability of financial institutions and regulators to deal with financial risks.

Keywords: Japanese bubble economy, real estate, financial stability, literature review method.

1. Introduction

By the end of the 1980s, Japan had witnessed an Economic Miracle lasting almost three decades, undergoing surging growth and boosting the real estate market. However, the hidden crisis and risks behind the prosperity gradually emerged. In the 1980s, a bubble gradually appeared in the real estate market in the Japanese economy, with an appreciation of the land and houses. The bubble continued to grow in the next few years , and the price of property and land kept climbing. In 1989, the property's price rocketed to a record height due to excessive speculation, and a precedent height was hit in the Japanese Nikkei 225 index [1]. After a while, the Japanese Nikkei 225 index dropped drastically and substantially, triggering the collapse of the real estate bubble [1]. After that, real estate prices plummeted for a long time, throwing the entire economy into a severe financial crisis and the long period of economic stagnation known as the Lost Decades [1].

A stable financial system is pivotal in maintaining economic stability and realising sustainable economic growth. The stability of the financial system enhances the ability of financial institutions to withstand internal and external risks and shocks. In this case, the financial institutions are more

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likely to function normally. If financial institutions operate properly, stable financial services can be provided. Therefore, this can avoid financial crises and economic recession to some extent. Moreover, if the stability of the financial system lowers, this would probably cause the outbreak of financial risks which further contributes to the collapse of financial institutions. In consequence, the safety of savings and other forms of financial assets, such as stocks and bonds will be jeopardised. Directly, the values of financial assets will fluctuate, resulting in a financial loss for investors and holders.

The real estate market frequently has a close relationship with financial stability [2]. The rapid growth and development of the real estate market correspond with the increasing property values due to appreciation in real estate [2]. This is accompanied by lower lending standards, making it easier for investors to access financing and increase borrowing through mortgage-backed securities to expand their portfolios in the stock market [2]. Hence, the stock price increases rapidly and becomes volatile, indicating low financial stability [2]. Moreover, the rising house price increases not only the value of real estate but also the value of the collateral of borrowers [3]. Thus, this accumulates bank capital, and increasing bank capital helps reduce risks to the bank's assets [3]. This further maintains the effective operation of banking systems, diminishing the likelihood of occurrence of financial crises [3].

The essay aims to focus on the formation and burst of the Japanese real estate bubble economy, analyze the influence mechanism of the Japanese real estate bubble economy on the stability of the financial system, and provide references for future financial supervision.

2. Formation and Collapse of the Japanese Real Estate Bubble Economy

2.1. Background of Bubble Economy

After World War Two, Japan is exposed to a significant number of economic opportunities to play catch-up. The devastating postwar economy recovered from the destruction of the productive potential during the war between 1945 and the mid-1950s [4]. Afterward, Japan witnessed a substantial economic boom from the 1950s to the 1970s before the Arabian oil supply shock. During the two decades, Japan maintained a swift economic growth rate of over ten percent annually [4]. Japan turned out to be the second-largest economy in the world on the cusp of history.

Moreover, the Japanese economy took the lead in manufacturing industries, with the expansion of the automobile and electronics industries [4]. The manufacturing products are worldwide famous due to the high quality, less expensive price, innovative technology, and efficient manufacturing approaches [1]. Meanwhile, Japan had continuously achieved a trade surplus [4], transforming the economy into a booming export-led economy.

However, the path to the fast-growing economy had not been smooth. In 1985, a historical agreement called Plaza Accord was signed to employ market intervention and other instruments to devalue the dollar against other major currencies, such as Yen and German Deutsche Mark to alleviate the US trade deficit and stimulate imports [1]. Plaza Accord had a profound influence on Japan's economy, contributing to the appreciation of Japanese Yen. This further affected the Japan's trade balance.

2.2. Prosperity and Speculation of the Real Estate Market

Japan mainly experienced two real estate crises. The first sub-phase occurred in 1970s [5]. At that time, the urbanisation and industrialisation caused inflation of property. Meanwhile, the first oil crisis in 1973 led to a global recession. To counter the stagflation, Japan adopted fiscal and monetary policies, globalisation and exchange rate adjustment. For instance, Japanese banks' tightening monetary policy cooled the rapid expansion of the real estate market. The second sub-period happened in 1990s as Japan experienced a booming bubble economy in the real estate market due to

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the prolonged loose monetary policy, the value of properties appreciated. Take Tokyo as an example, between 1980 and 1990, the price of commercial land increased sevenfold, one square meter was estimated around U.S. $279,000 [6,7]. In this case, both developers and investors anticipated a further rise in property values. Thus, there were larger amounts of speculative investment in the real estate market [6]. This ultimately resulted in the collapse of asset bubble.

2.3. Burst of Bubble

With the appreciation of real estate, the bubble economy rapidly expanded and peaked, ultimately it collapsed in the first half of the 1990s. At the end of the 1980s, the Japanese government gradually concerned about the increasing excessive real estate prices [1]. Without the support of sufficient employment, citizens could not afford to invest in the real estate market. Hence, this triggered a surplus in the real estate market. In response to the problem and potential risks, the loan interest and discount rate were raised [8]. These increased the cost of borrowing, which diminished investment. Additionally, the bank set a ceiling of borrowing for the real estate sector, which enhanced the borrowing standards for investors [4]. Consequently, these tightening monetary policies discouraged mortgage lending and constrained the rising price in the real estate sector, contributing to the collapse of the bubble.

The sudden devastating collapse had a disastrous impact on the Japanese economy. In addition, Japan was experiencing an aging population issue concurrent within the severe financial crash. In the near term, the aforementioned effects cause a recession and deflation [9]. From a macroeconomic perspective, the growth rate of GDP stayed at less than 1 percent between 1992 and 1995 [4]. From a microeconomic perspective, the property deflated, and the value of the real estate was reduced, thereby enormous investors had to bear the financial loss as they had invested excess funds in the land [4]. What is more, a significant amount of nonperforming loans was piled up on top of Japanese banks [4]. Due to this issue, the deposit insurance scheme and processes for notifying and dissolving weak and insolvent banks were introduced in 1995, along with other changes to the bank's overall policy [4].

3. Influence of Japanese Real estate Bubble Economy on the Financial Stability

3.1. Credit Expansion and Risk Accumulation

The extension of housing credit is typically regarded as beneficial since it eases the financial burden on investors, facilitating the process of land purchase [10]. However, excessive credit in the real estate sector can bring detrimental effects on the entire economy and financial stability [10].

During the bubble economy period, Japan witnessed the largest surge in housing prices [5]. The soaring property value incentivised speculation in land, thereby increasing demand for mortgage credits. Meanwhile, to satisfy higher demand for investment and economic growth, the Japanese bank gradually implemented a loose monetary policy in 1980s. More specifically, the real interest rate lowered between 1985 and 1987, with the discount rates of 5.0% in 1985 and 2.5% in 1987 [6]. Therefore, the credit standards turned out to be lax, and the availability of credits was enhanced. Japan became the biggest creditor nation in the world at the end of 1989 and all eight of the leading banks globally were Japanese [11].

However, the enormous growth of credit to the real estate sector can lead to risk accumulation. First, there would be increasingly risky borrowers in the real estate market as the borrowing standards declined [3]. These debtors might face a deterioration in their financial position with low credit ratings. Under the circumstance, that the debtors could not repay the loan principals and interests, the asset quality decreased [3]. More specifically, there was an increasing proportion of bad loans, signifying banks were facing a financial loss and diminishing profitability. Moreover, the over-expansion of

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credit reduced bank capital and restrained the capitalisation of banks. Further, this reduced the liquidity of banks, adversely affecting the adequate operation of the banking system.

3.2. Asset Price Bubbles and Financial Fragility

During the bubble period, asset prices increased tremendously and promptly. Hence, the market values of assets gradually deviated upwards from their fundamental values. More investors flooded into the real estate market and further pushed up the prices. According to the valuation estimations, the central district of Tokyo has an equal value to the entire United States, and selling Japan would allow individuals to purchase the United States four times over [11]. When the bubble burst, the price plunged, making the financial system more fragile.

The upward trend in asset prices implied a profitable prospect. However, due to adverse selection, both bank sectors and debtors might not be able to assess the fundamental value of the property accurately. Loans were pledged on houses of low fundamental values. Therefore, this resulted in a proliferation of hazardous assets that were vulnerable to mispricing [3]. When the gap between the housing prices and the fundamental values of the real estate was greater, the financial position of borrowers worsened [3]. After the burst of the bubble, those borrowers who purchased their homes before the bubble burst is unable or unwilling to service their debts [9]. As a result of their house's declining value, some homeowners who were also borrowers stopped making mortgage payments [9]. The houses used as collateral for mortgage loans belonged to the banks once the borrowers stopped making loan payments [9]. Nevertheless, banks are still unable to recoup the interest rates they charge on loans by selling or auctioning those homes [9]. The financial system became more fragile. After 1997, even a handful of banks eventually declared bankruptcy [9].

4. Conclusion

Based on the findings of this essay, the real estate bubble economy had a huge impact on the financial stability during the Japanese bubble period. This essay analyses the formation of Japanese bubble economy in the real estate market. The Japanese economy recovered swiftly and flourished after World War Two. The postwar economy not only took the lead in the manufacturing industry but also transformed to an export-oriented economy. Following the formation of the bubble, Japan went through a two-phase real estate boom. Subsequently, speculation contributed to the bursting of the housing bubble. The influence of Japan's real estate bubble on financial stability is also examined in this paper. Accompanied with the growth of real estate bubble, Japan implemented a loose monetary policy. The first effect is the excessive expansion of credit.which led banks to become less profitable and capitalized. Another effect is the asset bubble, which made the financial system more fragile.

The main contribution of the paper is to offer references for financial supervision in situations where the stability of the financial system is at risk. Effective monetary policy and appropriate supervision of banks and the government can be selected to mitigate the potential adverse consequences brought by the real estate bubble economy.

The current paper has its inadequacy. To illustrate, this essay primarily examined the detrimental effects of the Japanese real estate bubble economy on the stability financial system and solely addressed the real estate sector. The other facets of Japan's bubble economy could be incorporated, and the beneficial impacts of the real estate economy can be taken into account in future research.

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