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Causes of Japanese Real Estate Bubble and Post-crisis Policy Analysis

Yiwen Sun[1,a,*]

[1]Soochow University, Business school, Suzhou, 215006, China
a. yiwensun62@gmail.com
**corresponding author*

Abstract: In the late 1980s and early 1990s, Japan experienced a serious real estate bubble bursting and economic crisis. The crisis had a profound impact on the Japanese economy and led to the so-called "lost decade." Starting from the formation mechanism of the Japanese real estate bubble, this paper analyzes the economic and policy causes behind it, including monetary easing, insufficient supervision and speculative psychology. After the bubble burst, the Japanese government adopted a series of monetary and fiscal policies in response to the crisis, for example, lowering interest rates, implementing quantitative easing, and launching fiscal stimulus programs. These policies played a positive role in stabilizing the financial system, but the economy was Mired in a prolonged downturn because structural problems were not fully addressed. This paper takes Japan's economic policies in the period of the bubble economy as the starting point, discusses the dual role of the policies in stimulating economic growth and causing the bubble to burst, analyzes the root causes of policy failure and its far-reaching impact on financial stability.

Keywords: Japan, Real Estate Bubble, Plaza Accord Monetary Policy, Fiscal Policy

1. Introduction

As the world's second-largest economy during the 1980s, Japan experienced an unprecedented surge in asset prices, particularly in real estate and stocks. This economic phenomenon was shaped by a confluence of factors, including rapid urbanization, speculative behavior, and financial liberalization. The speculative fervor, underpinned by the belief that land prices would continue to rise indefinitely, encouraged widespread investment in real estate. By the late 1980s, property values in major urban centers had reached levels far exceeding their economic fundamentals. In the study of the bubble economy, the existence of a large amount of excess capital is an important factor contributing to the formation and development of bubbles. In the 1980s, Japan had a huge capital surplus. Since the middle of the decade, the Japanese economy has entered a period of slow growth, and favorable investment opportunities have decreased, but the supply of capital, especially large enterprises, has not decreased with the reduction of capital demand. This surplus capital is then used for financial investments and mutual shareholdings.[1]

The dramatic collapse of this bubble in the early 1990s had profound consequences for Japan. The bursting of the bubble triggered a financial crisis that destabilized banks and businesses, leading to a prolonged economic downturn often termed the "lost decade." This period was marked by deflation, stagnating wages, and a significant loss of investor confidence. The crisis revealed

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systemic flaws in Japan’s economic policies and financial regulations, sparking a need for substantial policy reform.

This paper seeks to analyze the causes of Japan’s real estate bubble, the reasons behind its eventual burst, and the policy measures implemented in its aftermath. By examining this critical episode in Japan's economic history, the paper aims to derive lessons for contemporary macroeconomic management, particularly in the areas of bubble prevention and crisis mitigation. Understanding the dynamics of Japan’s bubble economy provides valuable insights for policymakers facing similar challenges in today’s interconnected global economy.

2. Causes of the Real Estate Bubble

As Japan was mainly supported by the United States in its post-World War II reconstruction, the Japanese industry was rebuilt particularly rapidly after the war, and developed to a more developed degree than before the war. However, during the process of industrial development, many public hazards have emerged in Japan because of the neglect of environmental protection. These environmental issues have deteriorated the living conditions in rural areas, causing a large number of people to move to cities in pursuit of better living opportunities. Nevertheless, the acceleration of urbanization has further intensified the demand for residential land, especially in metropolises like Tokyo and Osaka. In 1962, the Japanese government began to restrict industrial land near the city; since 1963, the apartment construction boom, land investment for asset investment increased sharply, and the demand for residential land increased[2].

2.1. Financial Regulatory Policy Adjustment Errors

Following World War II, Japan underwent rapid industrialization and urbanization, which increased the demand for land and housing. By the 1960s, the government began restricting industrial land use near urban areas, further exacerbating the demand for residential land. Urbanization brought with it a cultural shift towards metropolitan living, driving up land values in cities like Tokyo and Osaka. Additionally, the rise of apartment construction in the 1960s fueled speculative investment in real estate as it became a preferred asset class. The monetary policy continues to be eased. In the mid-1980s, Japan carried out financial liberalization in order to conform to global trends. However, the regulatory frameworks were insufficient, which permitted speculative activities to boom. Also during this period, the Plaza Accord was signed in 1985, leading to a sharp appreciation of the yen. To mitigate the adverse effects on exports, the Bank of Japan adopted an excessively loose monetary policy, lowering interest rates to 2.5%, resulting in excessive liquidity in the economy. Meanwhile, financial deregulation enabled banks to lend extensively to the real estate sector, further inflating land prices.[3]

2.2. The Japanese Are Stubborn

In Japan in the second half of the 20th century, the "land myth" became a widely popular belief that land was a scarce resource whose price could only continue to rise rather than fall. This concept is rooted in the special background of Japan's geographical and economic development. Owing to Japan's limited land area and scarce available land, especially during the rapid economic development period, the tension between land supply and demand has driven up land prices. In addition, the rapid economic growth of postwar Japan, the acceleration of urbanization, and government policies to encourage real estate investment further strengthened the perception of land as a "safe asset." Driven by this myth, land is regarded as an investment tool to preserve and increase value, leading to the intensification of speculation in the real estate market and the constant inflation of asset prices. Under the influence of this belief, banks issued a large number of land - secured loans, further fueling the overheating of the real estate market[4].

3. The Reasons for the Bubble Economy Burst.

3.1. Japanese Demand is Weakening

In 1990, at the end of the bubble economy, Japan's urbanization rate had reached 77%, close to saturation. At this time, the increase in the urbanization rate gradually ceased, and the demand for urban real - estate purchases weakened. At the same time due to the boom in housing construction housing supply is sufficient and the oversupply caused by high housing prices has further accelerated the bursting of the bubble.

3.2. Japanese Aging Population

Demographic changes including an aging population and a declining proportion of the working-age population have further reduced the demand for housing. This structural problem exacerbates the fragility of the real estate market. The rapid aging of Japan's population has reduced the rate of household formation and dampened future demand for housing and commercial space.

3.3. The Japanese Government Made a Policy Mistake

The Central Bank of Japan suddenly tightened its monetary policy, adopted a tight monetary policy, and restricted its real estate loans, which largely became the main reason for the bursting of Japanese bubble economy. At the same time, the Japanese government's increased tax revenue on real estate also accelerated the bursting of the bubble economy to some extent. Although high transfer income tax can suppress land speculation [5] to a certain extent, land speculation is not characterized by short-term frequent turnover, and landholders are more willing to hold land for a long time to avoid high transfer income tax. Therefore, land transactions were suppressed during this period, but the opposite policy effect was achieved.

4. The Response of the Japanese Government to the Bursting of the Bubble Economy

4.1. Actively Promote Tax Reform

After the bursting of the bubble economy, the Japanese government adopted the measures of tax reform system. Although there were some mistakes, it generally stabilized the economy after the bubble burst crisis. After the measures to reduce the tax rate failed to curb the rapid decline of housing prices, the Japanese government fully learned from the experience and gradually increased the collection of tax on the real estate retention link, which greatly increased the tax revenue in the retention stage and effectively suppressed the real estate speculation.[6]

4.2. Hard Landing Policy

Under Prime Minister Koizumi Finance Minister Takenaka spearheaded reforms to address bad loans in the banking sector. [7]Koizumi's cabinet accelerated the disposal of banks' non-performing assets through financial reforms, requiring large banks to raise their capital adequacy ratios and liquidating or restructure substandard financial institutions. In addition, the government has implemented fiscal austerity policies, cutting public spending and social security, and strictly controlling the growth of government debt. These policies while painful in the short term have helped address the problem of non-performing assets and restored some stability to the financial system. The government's decision to pump public money into failed banks is controversial but ultimately necessary to restore confidence.

Since 1990 the Japanese government finance department has been requiring financial institutions to keep the quarterly growth rate of their real estate financing balances below the growth rate of total loans [8]. Since the peak of Japan's bubble economy in 1991 land prices have continued to fall. The move seemed to limit the wild rise in land prices but it was the straw that repelled the camels. The crisis spread further.

4.3. Promote the Effective Use of Land and Curb the Continuous Decline of Land Prices

In the depression period after the bubble economy burst the Japanese government put forward a land policy instead of suppressing land prices to promote the effective use of land. Since then the Japanese government has stopped the taxation of land value tax reduced the taxation of land transfer links and stopped the taxation of land holding tax[9].

5. Experience and Enlightenment of Japan's Bubble Economy

5.1. Emphasis on Macroprudential Policy

At that time, Japan lacked a systematic macro-prudential regulatory framework, [10], which failed to effectively prevent the accumulation of systemic risks. Increase taxes on holdings, such as real estate ownership taxes, to curb speculative purchases. At the same time, monetary policy should be adjusted dynamically. When asset prices rise rapidly, the central bank should raise interest rates or the deposit reserve ratio. Japan’s experience underscores the need for robust macro-prudential frameworks to prevent the excessive accumulation of systemic risks. Dynamic monetary policies and targeted regulations, such as limits on loan-to-value (LTV) ratios and debt-to-income (DTI) ratios, can mitigate speculative booms. A stronger focus on stress testing financial institutions for exposure to asset bubbles is also critical.

5.2. Avoiding Lagging Policy Responses

Delayed responses both before and after the bubble burst exacerbated Japan’s economic challenges. Establishing early warning systems that monitor asset prices, credit growth, and transaction volumes can help policymakers intervene preemptively. Swift action during the early signs of overheating can prevent excessive damage. The Japanese government was slow to react before and after the bubble burst, leading to lower asset prices and severe damage to the financial system. An early warning mechanism should be established to identify bubble signals in a timely manner by monitoring indicators such as asset prices, credit growth and transaction volume in the real estate market.

5.3. Strengthen Economic Restructuring

Japan's over-reliance on real estate and the financial sector has led to a balanced economic structure and long-term stagnation of economic growth after the bursting of the bubble. The economy should reduce the dependence of the real estate market on the economy promote the development of diversified industries and reduce the systemic impact of the real estate market on the overall economy.

5.4. Addressing Population Challenges

Japan's aging population is an important demographic trend that underscores the urgent need for comprehensive policy reforms to address the challenges posed by this transition. As the proportion of older persons continues to rise it is increasingly important to develop strategies that not only support the well-being of older persons but also maintain economic stability and social cohesion.

A key way to mitigate the effects of population aging is to promote migration. By welcoming skilled workers from abroad Japan can strengthen its workforce and fill critical gaps in a variety of fields including health care manufacturing and technology. Migrants can contribute to the economy through their labor and consumption helping to sustain economic growth and reducing the burden on the existing workforce.

Another key step is to increase the labor force participation of all age groups especially women and older workers. Encouraging flexible working arrangements such as part-time work remote working options and phased retirement schemes can help retain experienced professionals and tap the potential of the underutilized population. In addition, investing in education and training programs can equip workers with the skills they need to adapt to changing job markets and technological advances.

6. Conclusion

The Japanese real estate bubble and its aftermath provide valuable insights into the dynamics of asset bubbles and their economic consequences. This study explored the factors contributing to the bubble's formation, including post-war urbanization, financial liberalization, and speculative behavior, as well as the reasons for its eventual burst, such as policy missteps, demographic shifts, and oversupply. Additionally, the government’s post-bubble measures, ranging from monetary interventions to structural reforms, were analyzed for their effectiveness and shortcomings.

This paper highlights the importance of sound macroprudential policies and timely intervention to prevent asset bubbles. While the Japanese government implemented several reforms after the bubble burst slow response and structural inefficiencies limited their effectiveness. The study highlights the need for diversification of economic drivers sustainable real estate policies and proactive population strategies to mitigate vulnerability.

However this study has limitations. It relies primarily on previous studies and conclusions can be strengthened by a more in-depth quantitative assessment of specific policy impacts. Future research could employ econometric models to assess the effectiveness of individual interventions. Comparative studies with other economies experiencing similar asset bubbles can also expand the applicability of the findings.

Looking ahead policymakers can draw on Japan's experience to strengthen early warning systems improve regulatory frameworks and design adaptive policies. By addressing systemic risks and fostering resilient economic structures governments can better cope with the complexity of asset bubbles in an interconnected global economy.

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