RESEARCH REPORT

THE LOST DECADE(S): A COMPREHENSIVE ANALYSIS

FINANCE AND INVESTMENT CELL
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THE LOST DECADES: A COMPREHENSHIVE ANALYSIS

With the third-largest nominal GDP, Japan, a highly developed free market is the world's second-largest developed economy. It is a member of both the G7 and G20. On the outside, everything seems to be going smoothly for the nation. However, Japan has a history of economic turmoil and instability characterised by various initiatives taken by the government to uplift the nation.

Rising stock and real estate values caused an economic bubble in the second half of the 1980s. The Tokyo Stock Exchange fell in 1990–92, and real estate prices peaked in 1991, leading to the burst of this bubble. The term "Lost Decade" came about because Japan's growth was 1.5 per cent slower than the rest of the world throughout the 1990s. After another decade of sluggish growth, the moniker "Lost 20 Years" was coined. Due to Japan's large social welfare spending in an elderly society with a declining tax base, the country's national debt had grown significantly. There were too many empty houses in Japan, thanks in part, to the country's ageing population and preference for new residences over old ones. This phenomenon, commonly known as "Abandoned Homes", was spreading fast from rural to urban regions.

By 1998, Japan's public works projects had failed to generate enough demand to break the country's economic stagnation. In a desperate bid to curb speculative excesses in the stock and real estate markets, the Japanese government implemented structural reform policies. Unfortunately, Japan experienced deflation on several occasions between 1999 and 2004 as a result of these policies. To enhance inflation expectations and spur economic growth, the Bank of Japan employed 'quantitative easing' to expand the country's money supply. The policy initially failed to generate any growth, but it did eventually have an impact on inflationary expectations. Late in 2005, the economy began with what appeared to be a long-term recovery. GDP increased by 2.8 per cent in that year, with an annualised fourth-quarter expansion of 5.5 per cent YoY. Despite keeping interest rates at zero for a prolonged time frame, the quantitative easing policy failed to prevent price deflation.

The Bank of Japan (BOJ) had set a 2% inflation target in April 2013 to overcome deflation and achieve long-term economic growth. However, due to reduced global oil prices, it was unable to meet this goal and was compelled to adopt additional measures. As a result, the BOJ implemented a negative interest rate policy in February 2016 by dramatically boosting the money supply by acquiring long-term Japanese Government Bonds (JGBs).

PAST POLICIES

THE PLAZA AGREEMENT

The Plaza Accord was an agreement signed in 1985 between France, Germany, the United States, the United Kingdom and Japan in order to manipulate the currency rates by weakening the value of the U.S dollar against the Japanese yen and the German Deutsche Mark. This agreement was intended to remedy trade imbalances between the United States of America and Japan and USA and Germany, but it was only able to do so with the latter.

Intricacies of the Accord

▶ The Plaza Accord was signed on September 22, 1985, in New York City and is named after the Plaza Hotel, where it was signed.

▶ The agreement was designed to depreciate the US currency, with the US, Japan, and Germany committing to executing specific policy steps to accomplish this goal. The United States had committed to reducing its fiscal deficit.

▶ Japan and Germany were supposed to promote domestic demand by pursuing measures like tax cuts. To fix current account imbalances, all parties committed to intervening directly in currency markets as needed.

▶ The US dollar increased by about 47.9% from the beginning of 1980 to its high in March 1985, leading up to the Plaza Accord. As imported items were relatively cheaper, the strong currency put pressure on the US manufacturing industry. As a result, numerous big corporations, such as Caterpillar and IBM, lobbied Congress to intervene, resulting in the Plaza Accord.

Repercussions on Japan

1. The Plaza Accord cemented Japan's position as a key participant on the global stage. However, an unforeseen effect of the Accord was for Japan to develop trade and investment with East Asia, reducing its reliance on the United States.
2. A rising yen, on the other hand, may have aggravated Japan's recessionary difficulties. It hit Japan's export-based businesses hard in the short run.
3. To counteract the consequences of the shock, the Japanese government launched a large expansionary monetary and fiscal policy in an attempt to stimulate the domestic economy.
4. Through the late 1980s, this tremendous macroeconomic stimulus, together with other measures, caused massive credit and asset price bubbles in Japan's financial and real estate sectors. When this bubble burst, Japan went through a time of low growth and deflation that lasted throughout the 1990s and 2000s. As a result, the Plaza Accord aided in the propagation of Japan's "Lost Decade".

WINDOW DRESSING

Window guidance is an unofficial monetary policy tool in which the Bank of Japan (BOJ) and the Prime Minister's agency request commercial banks to finance a specific company, industry, goods, or service, typically to fund the nation's military-industrial complex.

▶ In late 1989, the Bank of Japan raised inter-bank lending rates sharply in an attempt to deflate speculation and keep inflation under control.
▶ The bubble burst as a result of this harsh policy and the Japanese stock market crashed. Equity and asset prices fell, leaving Japan's overly leveraged banks and insurance companies with a mountain of bad debt in their books.
▶ The financial institutions were bailed out with government capital infusions, central bank loans and cheap credit, and the ability to postpone loss recognition, eventually turning them into zombie banks. According to Yalman Onaran of Bloomberg News, writing in Salon, zombie banks were one of the causes of the subsequent long stagnation. Furthermore, Time magazine's Michael Schuman reported that these banks continued to inject new funds.

Many of these failing firms eventually became unsustainable, and a wave of consolidation occurred, resulting in four national banks in Japan. Many Japanese companies were saddled with massive debts, making credit extremely difficult to come by. Many borrowers sought loans from sarakin (loan sharks). The official interest rate in 2012 was 0.1 per cent and the interest rate has remained below one per cent since 1994.

Window guidance in Japan appears to teach its neighbouring country a lesson: progress in financial liberalization erodes the validity of window guidance over time, making interest rate policy more important as a monetary policy instrument.

THE LOST DECADE(S)

"Lost Decade" refers to the decade-long economic turmoil that Japan endured in the 1990s. Japan's economy grew rapidly in the decades following World War Two, reaching a peak in the 1980s with the world's highest per capita Gross National Product (GNP). During this period, Japan's export-led growth attracted capital and resulted in a trade surplus with the United States.

To reduce global trade imbalances, Japan signed the Plaza Agreement with other major world economies in 1985. As a result of this agreement, Japan embarked on a period of loose monetary policy in the late 1980s. Due to this loose monetary policy, stock prices rose and real estate valuations soared which eventually led to the development of the real estate bubble in the economy. As it became evident that the bubble was about to burst, the Japanese Financial Ministry raised interest rates. The stock market crashed and a debt crisis occurred, halting economic growth and resulting in what is now known as the Lost Decade.

In the 1990s, Japan's gross domestic product (GDP) averaged 1.3%, significantly lower than other G-7 countries. Savings in the household increased but this didn't lead to an increase in demand, leading to deflation. The GDP growth rate in Japan in the following decade averaged just 0.5% per year as a result of sustained slow growth until the Global Financial Crisis. Consequently, many refer to the period between 1991 and 2010 as the Lost Score or the Lost 20 years. After this, Japan's GDP grew at an average of just under 1.0% per year from 2011 to 2019. The year 2020 lead to the onset of another economic hindrance as the government shut the economy in reaction to the COVID-19 pandemic. Therefore, the years from 1990 till the present are collectively called the Lost Decades.

CAUSES OF THE CRISIS

A majority of economic crises immediately follow economic booms where valuations lose touch with reality. For example, the dot-com bust and the Great Recession in the United States followed several record-setting stock market valuations.

- The Lost Decade of Japan was also caused by

the stock market and real estate speculation during a boom cycle. Low-interest rates fueled stock market and real estate speculation that sent valuations soaring. The value of public companies and property more than tripled to the point that a three-square-meter area near the Imperial Palace was sold for $600,000.

▶ As property and stock prices both fell, the assets of companies and banks became less valuable than their liabilities as the Bank of Japan raised interbank lending rates to stabilize the market filled with bad loans.
▶ Other non-economic factors were Japan's ageing population and the rise of China and other East Asian competitors.
▶ In the Keynesian view, there have been several explanations for the slump in Japan. Paul Krugman argued that consumers were trying to hold onto their savings because they often feared that the economy would deteriorate.
▶ Monetarist economists have instead criticised Japan's monetary policy before and during the Lost Decade for being too restrictive and insufficiently accommodative to restart growth.
▶ Austrian economists, on the other hand, argue that prolonged economic stagnation is not inconsistent with Japan's economic policy, which intervened to support existing firms and financial institutions rather than allowing them to fail and give entrepreneurs the freedom to create new businesses and industries.
▶ The repeated bailouts of the economy and financial sectors are cited as the cause (rather than the remedy) for Japan's Lost Decade(s).

IMPACT ON THE JAPANESE ECONOMY

▶ Japan's economy, as a whole, is still recovering from the effects of the 1991 financial crisis and the ensuing Lost Decades.
▶ It took 12 years for Japan's GDP to return to the pre-crisis levels. Japan has also fallen behind in terms of output per capita, which is a further symptom of economic turmoil.
▶ Japan's actual production per capita was 14 per cent greater than Australia's in 1991, but by 2011, it had fallen to 14 per cent behind Australia's levels. Despite being a former world leader in both, Japan's economy has been overtaken not only in gross output but also in labour efficiency during the last 20 years.
▶ Japan was still facing the impacts of the Lost Decades more than 25 years after the first market crisis. Several Japanese policymakers, on the other hand, have undertaken changes to solve the Japanese economy's ills.
▶ Since the economic crisis created a prolonged period of stagnation that still affects the country today, the impact of the Lost Decade is still widely felt well beyond the ten-year mark.

AFTER THE LOST DECADES

The Lost Decade was not limited to the bubble that Japan faced in the 1990s but went on till the 2011-2021 decade. The Financial Crisis of 2007-08, the devastating earthquake, tsunami and the Fukushima nuclear disaster in 2011 and the COVID-19 Pandemic in 2020 further slowed the pace of growth of the Japanese economy.

THE GLOBAL FINANCIAL CRISIS

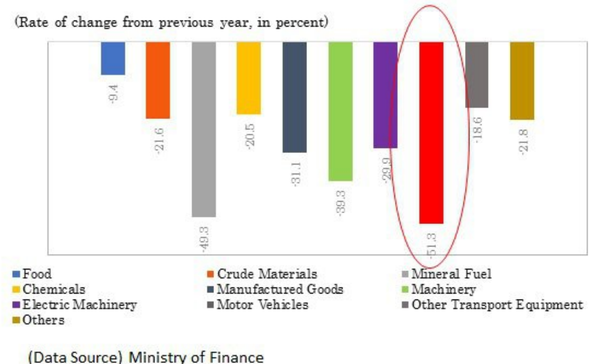
The Global Financial Crisis of 2007-2008, which began in the United States, had a profound influence on almost all of the world's economies, including Japan.

▶ The Japanese economy shrunk 3.3 per cent in the fiscal year ending March 2009.
▶ The trade deficit hit ¥223 billion in November 2008 and reached a record ¥952.6 billion in January 2009.
▶ GDP declined 12.1 per cent in the October to December quarter in 2008 and crashed 14.2 per cent in the January to March 2009 quarter.
▶ The unemployment rate rose to a high of 5.7 per cent in August 2009.

These were some numbers that displayed Japan's grim plight and attested to the fact that the Japanese economy never fully recovered from the financial crisis and deflation that followed the bursting of the 1980s asset price bubble. Although the policy goal of overcoming deflation was trumpeted for years in Japan, it was never convincingly achieved.

Huge Fall in Exports

Although the major factor behind the collapse of Japanese exports was a worldwide shrinkage of demand and trade following the Lehman shock, the sharp appreciation of the yen was an additional blow to Japan's export-oriented firms. From ¥7,360 billion in September 2008 to ¥3,480 billion in January 2009, the exports collapsed drastically. Major export categories consisted of highly income elastic industrial supplies, capital goods and consumer durables. During the crisis both, the export of consumer durables to the West and industrial supplies to the emerging Asian nations saw a sharp decline, which was a major reason for the plunge in GDP.



(Data Source) Ministry of Finance

THE TRIPLE DISASTER

Earthquake, Tsunami and Nuclear Disaster in Japan in 2011 led to massive destruction in the country. Economic losses were equivalent to $360 billion. The financial implications spread throughout East Asia, even affecting Japan's partnerships with the United States. Stock markets dropped, paper values shrunk and international trade was severely affected. Japan's real GDP contracted by 3.7% from January to March 2011. The biggest car manufacturers in the country like Toyota, Nissan and Honda were forced to suspend their production of cars. Small, medium and micro-businesses had lost their way of earning, suppressing the livelihood of the owners and workers as well.

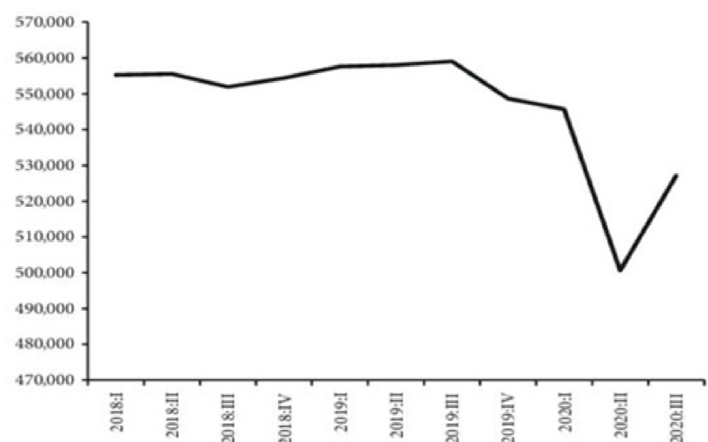
Japan lost its human and physical capital. 25,000 people were killed or were missing after this devastating disaster. Supply chain disruptions, job losses, the decline in trade and tourism, safety hazards, reduced capacity for electricity generation, increase in general price levels and overhead expenses made things worse for the country, thereby becoming the costliest natural disaster on record.

However, as always Japan, took no time to rebuild itself into one of the largest growing economies in the world. ¥31.3 trillion were spent by the country to get it back on track - an amount equivalent to Egypt's economy along with planned spending of ¥1.6 trillion in the next five years.

COVID-19 PANDEMIC

The Covid-19 pandemic had a devastating impact on all the economies globally. The various lockdowns that were enforced disrupted trade and industry resulting in a decline in the GDP growth rate of many major economies. Japan was no exception.

The Japanese economy contracted by 4.8 % in 2020 which was reported as its first economic contraction since 2009. The world's third-largest economy suffered its worst drop since WWII between April and June at 7.8 %, following the declaration of an emergency. In the first quarter of 2021, the economy shrank an annualised 5.1%, mainly due to a 1.4% drop in private consumption.



Source: Cabinet Office, Government of Japan.

Among the sectors that were hard hit were hospitality, food and beverage, entertainment and the life-related service industry. All suffered a great deal as they are premised on work that requires interpersonal contact which was not possible, thus adversely impacting revenues. The service industries had the highest number of bankruptcies (300) among the total 630 recorded, surpassing the total in 2010 (537), the year with the highest number of bankruptcies in a decade.

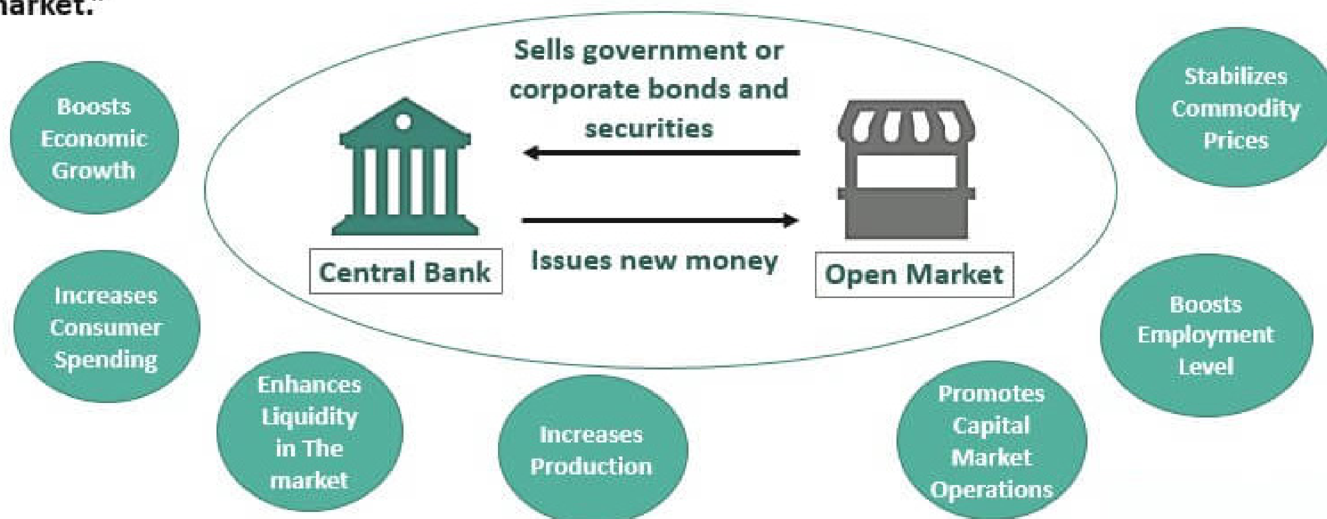
The unemployment rate rose for the first time in 11 years as there was a fall in the job availability ratio by 0.42 points to 1.18. The number of unemployed people in 2020 increased from 290,000 to 1.91 million and the number of non-regular workers decreased by 1.07 million from January to June 2020. Female non-regular workers were the worst sufferers. According to the Ministry of Internal Affairs and Communication, the number of non-regular workers decreased by 1.07 million from January to July 2020, out of which 900,000 were women. A survey conducted by Nomura Research Institute revealed the predicament of women where they expressed their anxiety and worry about the economic situation. Experts raised their concern about the lack of income compensation for the people asked to sit at homes

MEASURES TAKEN

With the aim of reversing the state of the Japanese economy following the real estate crisis and the Lost Decades, the Bank Of Japan released two major monetary policy tools- Quantitative Easing and Negative Interest Rate.

QUANTITATIVE EASING

"Quantitative Easing is a central bank's corrective measure to induce new money in a slowing economy by large scale buying of government or corporate securities from the open market."



After having maintained short-term interest rates at close to 0 since 1999, the Bank of Japan adopted the policy of quantitative easing on 19th March 2001 to fight domestic deflation in the early 2000s. To promote private lending and combat liquidity shortage, the Bank of Japan started purchasing government bonds, asset-backed securities, and equities and extended the terms of its commercial paper-purchasing operation thereby commercial banks were flooded with excess reserves.

Functioning

In order to increase the money supply in the economy and encourage lending and investment activities by the consumers, in a situation where short-term interest rates are either zero or approaching zero, the Central Bank starts purchasing longer-term securities like government and corporate bonds, mortgage-backed securities etc. from the open market using new bank reserves created in its balance sheet. This monetary policy of increasing liquidity in the economy by buying such securities is called quantitative easing. Since fixed-income securities are bid up, this policy helps in providing banks with more liquidity, hence helping in reducing interest rates further and spurring economic growth.

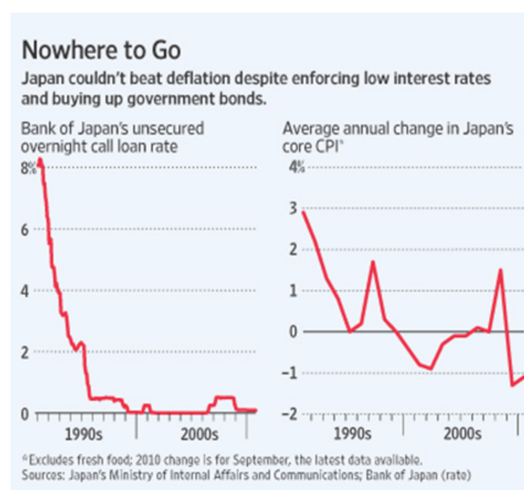
PROS	CONS
Avoids the situation of cash crunch by increasing the liquidity of financial institutions.	The risk of inflation is prevalent as consumers start demanding more from the same level of resources available in the economy.
Interest rates decline further, encouraging consumers and businesses to borrow more.	Devaluation of domestic currency can lead to costlier imports, thereby increasing the overall cost of production and consumer price levels.
Lower returns on fixed income assets shift investors towards other high yielding assets like stocks, hence improving the overall stock market scenario.	Stock market and asset bubbles may be created with the increase in speculative activity.
Increases confidence in the economy and reassures the market.	Might lead to an increase in income inequality as it is difficult to track whether the dissemination of credit in the economy is beneficial to all or not.

Japan's Experience:

Japan's new monetary policy framework had the following three objectives-

1. To increase current account balances of financial institutions with the Bank of Japan and provide ample liquidity.
2. To ensure stability and to increase Consumer Price Index (CPI) year on year.
3. To increase the purchase of Japanese Government Bonds upto a ceiling of banknotes issued.

During the period 2001– 06, Current Account Balances (CABs) rose gradually from about ¥5 trillion to a peak of ¥36 trillion in 2004 before declining at the end of the quantitative easing period in 2006. Unlike the commitment under Zero Interest Rate Policy to continue until the deflationary concern is dispelled, the commitment of the Quantitive Easing Policy (QEP) was linked to the actual track record of CPI. The Bank of Japan expected the CPI to grow positively year-on-year after it turned positive in November 2005 and felt that the purpose of the QEP was fulfilled. Hence, it decided to exit this policy post-2006 and focus on keeping the call rate low, thereby influencing banks to lend more.



Even though studies have found that higher CABs and long-term Japanese Government Bonds helped in reducing yields and credit spreads, the impact on economic activity and inflation was limited. This was because of a dysfunctional banking sector with inefficient credit channels post the banking crisis of the late 1990s and weak demand for loans during a time period when corporates were trying to reduce their debt.

THE WALL STREET JOURNAL.

January 29, 2016

Bank of Japan Introduces Negative Interest Rates

NEGATIVE INTEREST RATES

In order to tackle its economic woes and reduce deflation, on 29th January 2016, the Bank of Japan announced its resolve to adopt a multi-tiered interest rate regime. The new system divided the outstanding balance of each account at the BOJ into three tiers and a positive, zero or negative interest rate was applied to each one. This move came in line with Japan's consistent efforts to achieve its target of 2% inflation introduced by BOJ in April 2013. This measure aimed to promote banks to offer credit and provide a boost to household spending and business investments.

Functioning

Under a negative interest rate policy, there is a reversal in the rules of economics and the depositors are to pay charges to park their excess funds. In this scenario the depositors were banks. Just as normal people deposit money with banks, in a similar fashion, banks deposit their surplus money (cash beyond required for security reasons) with the Central Bank. With the rates turning negative the banks were to pay a fee for this purpose, thus in a bid to avoid such a charge, banks were discouraged to park funds with the central bank and rather use the money to lend more credit, stimulating growth.

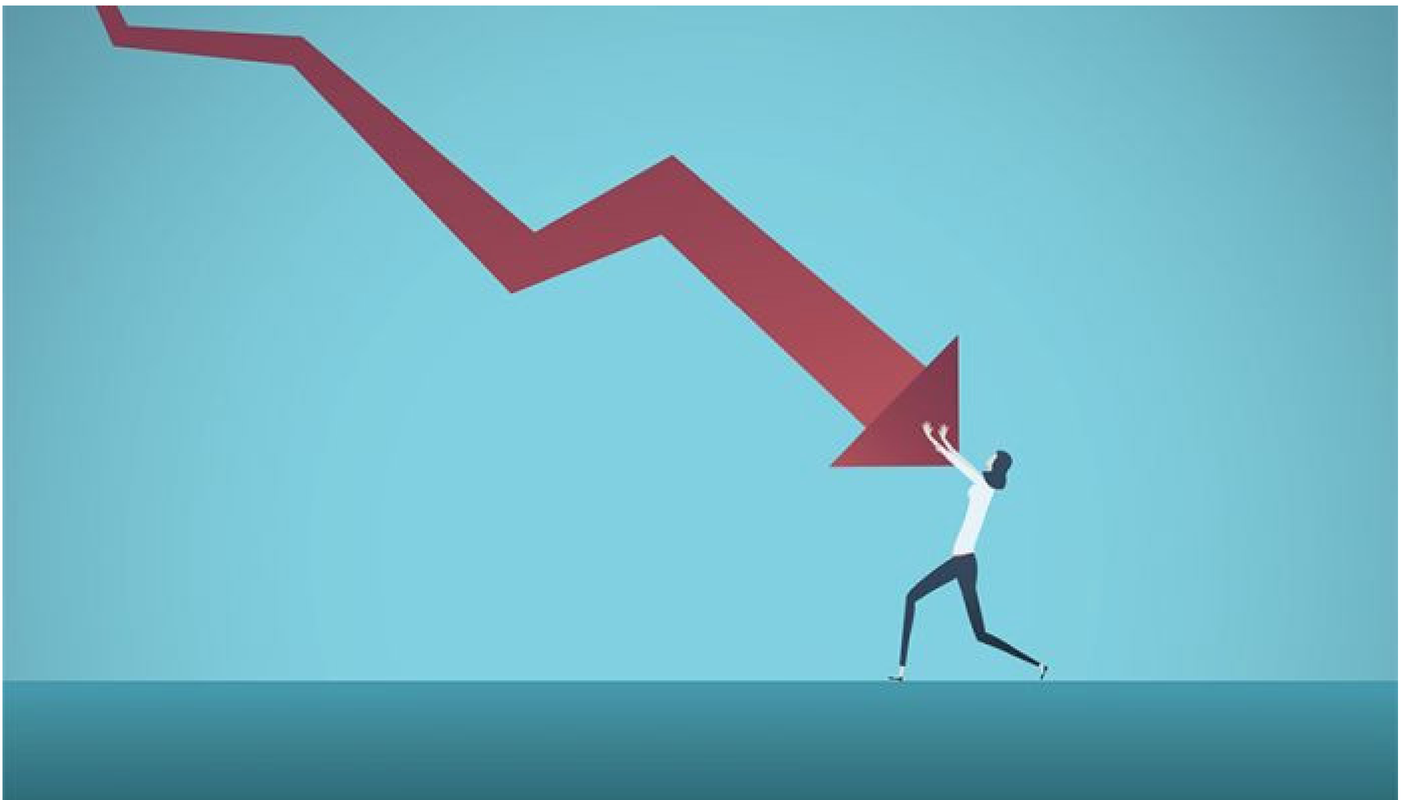
PROS	CONS
This acts as an incentive for banks to lend more.	This could backfire since it reduces profitability for banks.
This lowers borrowing costs for businesses and households.	This can push people into excess borrowing.
This can give a competitive edge to exporters by weakening a country's currency.	This could lead to runaway inflation.

Japan's Experience:

Japan had a twofold motive when it brought the interest rates to as low as -0.1%:

1. Encourage borrowing, spending and investment.
2. In cases when the national governments are in severe debt, low-interest rates make it easier for them to afford interest payments. An ineffective low-rate policy from a central bank often follows years of deficit spending by a central government. On the other hand, an effective low rate policy will substantially reduce the expenditures of a government, therefore, keeping the deficit in check.

However, the results have not been very encouraging with the country continuing its tryst with deflation. The negative interest rate policy initially succeeded in discouraging commercial banks to park their funds with the central bank, but failed to achieve the ultimate aim to stimulate greater lending. One of the primary reasons for this, as identified by various economists, is that negative rates lower the profit margin of banks. "If they're unwilling to lend because there's no profit in doing so, then they're not going to. As a result, you don't have the investment, you don't have the credit creation." said Jim Caron, a portfolio manager at Morgan Stanley. Therefore, contrary to expectation, the commercial banks found other avenues of investment. In order to overcome the barriers at home and garner profits, the banks in Japan resorted to foreign investments. Some studies showed how banks were more willing to lend to riskier firms in order to boost their profits. Also, the mere availability of cheap credit does no good if businesses and households are not willing to spend. Given Japan's ageing workforce, which was inclined more towards saving, a need for structural changes was felt.



COMPARATIVE ANALYSIS: A GLOBAL OUTLOOK

SOUTH KOREA

The East Asian countries, Japan and South Korea bear a striking resemblance in their economic problems. Despite straining political relations between the neighbours for the last few decades, Japan and South Korea have witnessed enormous economic growth. Japan continues to be the world's third-largest economy, with a per capita GDP of $39,286. South Korea is the eleventh largest economy in the world and has gradually reached a per capita GDP of $31,362.

Both nations also share unique domestic issues: an ageing society. It is believed that a birth rate of 2.1 is required to maintain a stable population. According to the data estimated by the World Bank, in 2019 the birth rate in Japan was 1.45. The situation was even worse at 0.98 in South Korea. A major survey conducted by the South Korean government in 2014 concluded that if the fertility rate, which was 1.19 at that time, did not increase, the country would face "natural extinction" by 2750. Unfortunately, over the years both countries have witnessed only a consistently falling birth rate, indicating gloomy future prospects for the economy.

Interestingly, despite economic growth, deflationary pressure is yet another similarity in these nations. In 2019, a senior economist at the credit rating agency S&P termed the deflationary pressure as the single largest domestic risk to the economy of South Korea.

Background

The South Korean financial crisis of 1997 was caused by two major government policy failures in the exchange rate and industry. When the US dollar appreciated, the South Korean Won also appreciated because it was arbitrarily fixed to the US dollar. Thereafter, under the government-managed exchange rate, the Won was devalued by up to 95% against the dollar. This led the majority of foreign currency-denominated loans to become uneconomical and borrowing firms to become insolvent. During this period, the short-term debt was $100 billion and the daily repayment of debt was about $1 billion. There were no foreign buyers for the Won and foreign funds were not flowing. At the same time, the government prevented the currency exchange market from obtaining foreign currency.

Despite the severe shortage of foreign funds, the South Korean

government spent extravagantly on its first loan of nearly $6 billion from the IMF in order to retain the overvalued Won by exchanging foreign currency. After the failures, the government realized that the Won had become unfeasible and it was floated. The government's mismanagement of the Won's exchange rate was a huge cause of South Korea's bad loans. Even after floating the Won, the cost of repayment of foreign debt significantly rose and became much larger than the original borrowing.

Another consequence of the government's attempt to maintain the overvalued exchange rate was that the interest rates in the country became excessively high. If the government had not pegged the Won and allowed it to float many years earlier, the interest rates would not have gone up. The interest rates had to rise to very high levels for attracting funds from foreigners since the overvalued Won had previously increased the cost for foreign lenders and investors. This further imposed a heavy burden on the companies in South Korea, leading to many corporate collapses.

There was also a domestic moral hazard involved in causing the crisis. Banks worked on the assumption that if they take loans as per the government's wishes, the government will save them from default on repayment. Self-interest occurs in both markets and governments but because of the enormous power of the government, corruption is more prevalent there. The combined effect of the government's interference in the Won exchange rate and the government-led lending and investment resulted in the South Korean crisis.

Measures taken for Financial Recovery

Since 1998, South Korea has brought many reforms in the financial sector. These are mainly focused on achieving two similar goals:

1. Ensuring that a similar crisis does not happen in the future by correcting the balance sheets of financial institutions.
2. To create a financial system that will help the country grow with stability.

Some of the reforms are as follows-

A) Strengthening legal and regulatory infrastructure – The first thing Korea needed in this time of distress was a healthy financial structure that can be laid as the basis to implement reforms. On December 27, 1997, thirteen financial bills were passed. This also included a bill to establish consolidated financial supervisory authority and was based on recommendations by the Presidential Financial Reform Commission. The Financial Supervisory Commission (FSC) was formed on April 1, 1998. Moreover, a Financial Supervisory Service (FSS) was formed to act as an administrative body for FSC. Both of these bodies had the sole authority to order

write-offs, mergers, suspension and closure of ailing financial institutions. In addition to this, Korea Asset Management Corporation (KAMC) was restructured to facilitate the purchase of non-performing loans from banks and other institutions.

B) Strengthening prudential regulations- The Korean government gave strength to its monetary system by introducing a better asset classification approach. This policy took into account the future performance of borrowers along with their track record in debt servicing. These asset classification rules were further improved in March 2000 by classifying those loans with high future risks as non-performing even if interest payments have been made on time. Other measures the FSC took to strengthen prudential regulations included placing limits on lending by banks to large borrowers, strengthening short-term foreign borrowings by banks and regulating all disclosure requirements of monetary institutions.

C) Reducing moral hazards- Korean Government also made many policies to improve the stability of its financial system by eliminating moral hazards. The most important reform in this sector was the introduction of partial deposit insurance. Earlier, people used to think that their assets were fully secured and insured by the government. However, now the deposit insurance limit was set at 50 million won per person for each financial institution. This policy helped discipline the market by giving incentives to depositors to seek out healthy financial bodies. Of the 30 large business houses, 14 had gone bankrupt or entered into out-of-court workouts by the end of 1999. This proved that the government's guarantee scheme had indeed ended. Though the policy was opposed by many in the beginning as they believed that it would increase the instability of the monetary system, the policy proved to be a boon as it helped in strengthening the financial structure of Korea.

D) Promoting capital account liberalisation- To regulate capital account transactions easily, the Korean government took various measures. For example, the foreign exchange rate system was made flexible in December 1997. Foreign mergers and acquisition limitations were removed in 1998. Moreover, foreign investment in Korean equities listed on the Korean Stock Exchange and KOSDAQ was fully liberalised in 1998. Foreign investment in Korean bonds was also fully deregulated in the same year. Land ceiling norms for foreign investors were also removed. Now, there was no prior permission needed to carry out international capital account transactions.

E) Strengthening corporate governance of financial institutions- To empower the governance of financial bodies, many steps were taken by the government of Korea. Foreigners were authorized to own commercial banks in Korea and even become bank executives. This improved management of financial institutions and even strengthened

the rights of small shareholders. The limit of bank ownership of domestic residents was raised from 4% to 10% in 2002.

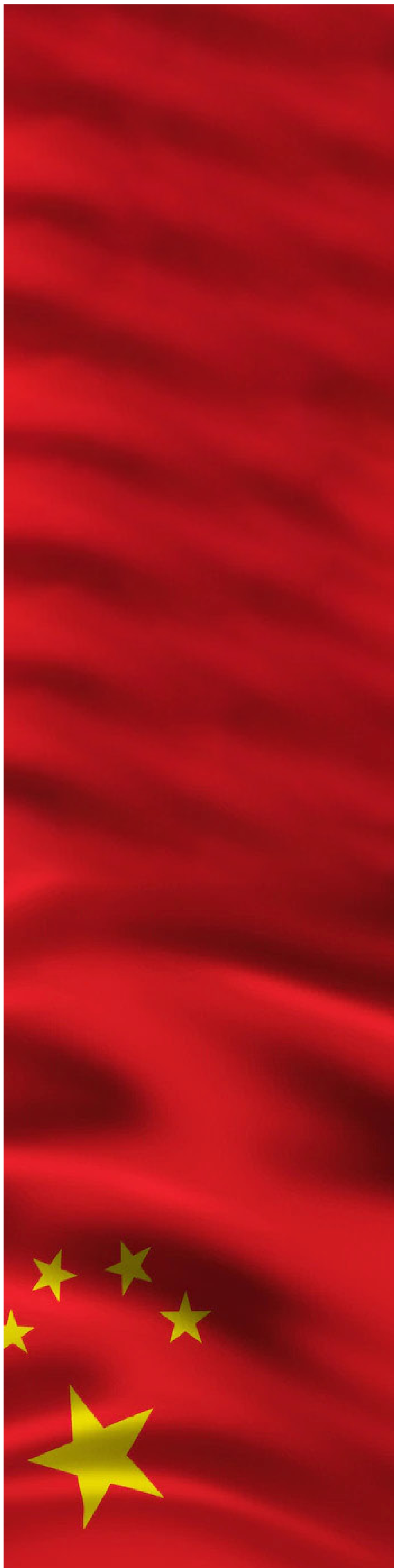
F) Rehabilitating the banking sector - Korea's banking sector saw two major setbacks-

- Inadequate capitalisation
- Poor quality of assets

The balance sheets of these banks were filled with non-performing assets. To solve this problem, the government took the help of public funds. This idea was controversial; however, the government had no other choice. So, the government decided to inject public funds to save its drowning monetary system. Earlier, only those loans which had been due and not paid for six months were classified as non-performing loans but now, loans in arrears for three months were also included in this category. Using this strategy, Korea's non-performing loans (NPLs) were estimated to be about 118 trillion won or 28% of Korea's GDP. To tackle the situation, the government raised funds through bonds issued by KAMCO and Korea Deposit Insurance Corporation (KDIC) and disbursed 160.4 trillion won by 2002. One-fourth of this was used to settle deposit insurance obligations and provide liquidity to the country's financial system while the rest was used for recapitalisation and purchase of those NPLs with recovery prospects. Many banks were closed and some restructured too.

G) Restructuring of non-banking financial institutions- Many merchant banks were engaged in activities such as limited deposits, loans, securities investment, international financing and leasing. After the bankruptcy declaration of the Hanbo group, merchant bankers found themselves under the burden of NPLs. The subsequent bankruptcies of big business houses in the country worsened the situation. As a result, restructuring of these financial institutions took place. 14 merchant banks were shut down, licenses of 22 banks were revoked and 3 merchant banks were merged with other banks. Hence, the number of merchant banks reduced from 30 in 1997 to 3 in 2003. Other non-bank institutions including securities companies, insurance companies, investment trust companies, mutual savings and financial companies, credit unions and leasing companies went through a similar restructuring process.

Although the economic conditions in South Korea and Japan vary, both countries faced the same financial enemy- deflation. The approaches of the nations differ on some counts. One key difference in the manner in which South Korea and Japan reacted to deflationary risk was that Japan focussed on adjusting its monetary policy to control deflation, whereas South Korea addressed the reasons for low inflation such as insufficient regulation in banks and non-banking financial institutions. Since South Korea has been more successful in defeating this adversary, Japan can incorporate some of the measures undertaken by South Korea.



CHINA

Similarities can be found between the real estate crisis in Japan and the ongoing Housing Bubble in China, especially with regard to the potentially catastrophic impact on the economies. Real estate development began in China in 1981. It was the Golden Period of the industry when a policy that required government agencies and corporations to provide permanent residences to employees was abandoned. After the financial crisis of 2008, new regulations introduced by the government led to a boom in residence trading and the real estate industry reached its peak. However, later from 2013 to 2015, after steady growth in prices, the speed of real estate growth slowed down. This led to a major deflation of the Chinese Housing Bubble, adversely impacting the country's economic growth.

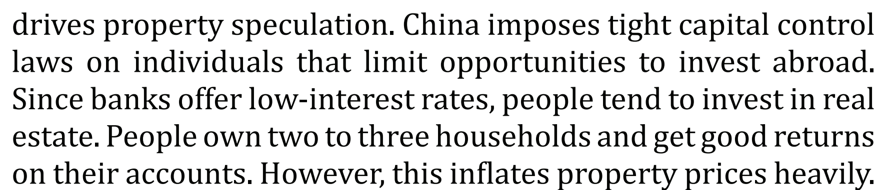
China's Evergrande Group has accumulated debts of more than $300 billion and the company already missed its payments on December 6, 2021. However, the question is, what are the reasons for the collapse of such a business giant and why is there a bubble growing in China's property market?

Causes of the Crisis

A) Bad monetary arrangements in China – China's local governments have an incentive to inflate real estate prices. There has always been a conflict of interest between central and local governments in China. The percentage of local government's tax revenue decreased from 80% in 1993 to approximately 45% after 1994 while the proportion of its expenses increased from about 68% in 1990 to 75% in 2004. This has left the local governments to deal with a huge fiscal gap. To tackle this problem, local governments resort to land transferring fees, which act as a major financial resource for big cities. Chinese law states that only the government can convert rural areas into urban areas. So, real estate developers usually pay high prices for the rights to use this land. Thus, local governments are prompted to inflate real estate prices in their areas.

B) Regulatory shortcomings - In China, a large amount of liquidity that should have gone to manufacturing and other sectors has instead gone to the housing sector. This has further inflated residential real estate prices. In addition to this, there are three main structural issues that the Chinese government need to address to overcome the problem-

- Housing market regulations are inadequate.
- Support for low-income groups has not been provided by the government.
- Terms of credit for residential purchases and investment purchases are not correctly differentiated.
- Financial repression-Speculation from individuals inflates real estate prices too. The government policy to keep wealth in China



drives property speculation. China imposes tight capital control laws on individuals that limit opportunities to invest abroad. Since banks offer low-interest rates, people tend to invest in real estate. People own two to three households and get good returns on their accounts. However, this inflates property prices heavily.

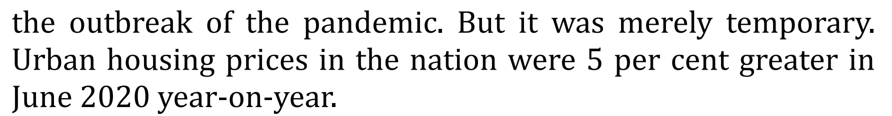
C) China's state capitalism crisis- Local governments, developers and many urban households have been pushed deep into debts because of China's economic growth model. The model has resulted in oversupplying of housing which is reflected by many empty high-rise developments in the country.

The Housing Crisis in China

Property developers in China are indebted with over $5 trillion. This debt, taken when property prices were continually rising, has doubled in the last four years. The amount is so high that it can be compared with the economic output of Japan, the world's third-largest economy. In early October, the Fantasia Holdings Group failed to repay corporate bonds. Kaisa Group had failed to pay bonds six years ago. One of its subsidiaries missed the deadline to pay for its wealth management products. The company described the reason to be as an "unprecedented pressure" on its finances due to difficult market conditions. The top 100 developers in China witnessed a fall in sales by more than 35% year-over-year in September 2021 according to data released by the China Real Estate Information Corp. (CRIC). The top 10 developers, including the Evergrande Group, saw their revenues decline by almost 45% year-over-year.

The prices in China for new homes fell for the first time in September 2021. The prices have fallen by 0.08 per cent in September 2021 as compared to August 2021. This marked the first decline since March 2015. Homebuyers in China have halted purchases and are trying to get out of the housing market after the fallout of the Chinese Evergrande Group and government restrictions sharply affected the sector. According to a New York Times report, the previously booming housing market in China is now seen as "a national threat" as prices rise sky-high. Beijing is trying to tame this market, where prices have been rising for years. The housing market did not stop booming when the coronavirus struck the country at the end of 2019. The market has experienced a relentless journey to the moon in recent years, and investors are looking for a deal, despite rising prices. In March, 288 apartments in New Shenzhen were sold online in 8 minutes. Similarly, Suzhou buyers bought 400 units as such. This resulted in an asset bubble.

Economists are afraid that this bubble far exceeds the bubble seen in the US housing sector in the 2000s. Investors invested $900 billion a year during the height of the US housing boom. Between June 2020 and June 2021, Chinese investors had invested about $1.4 trillion. The market took a breather after



the outbreak of the pandemic. But it was merely temporary. Urban housing prices in the nation were 5 per cent greater in June 2020 year-on-year.

Beijing is currently trying to cool its real estate market. The government of China has strengthened its policies to limit overexploitation, curb debt and save cash. The government does not want prices to rise because it goes against the recent "common prosperity" approach, which calls for "adjusting excess income" and encouraging high-income individuals and businesses to give back more to the society. This drive seeks to address inequality between the middle and upper classes, as seen when cracking down on the internet and tutoring companies. These rules expose the vulnerabilities of Chinese developers who were booming behind a business model that relied on borrowing for construction. The Chinese real estate group, Evergrande, has already addressed these restrictions by defaulting on a few important payments.

Potential Ramifications

In an attempt to cool down the property market, China may end up slowing down its growth. This sector accounts for a quarter of the nation's gross domestic product, a proportion which is higher than the USA. If these restrictions continue, China's growth rate can fall from 6 per cent to 3-5 per cent in the coming years, according to a report in the Wall Street Journal. China's international junk bond market has suffered the most in this fallout. Junk bonds have a higher risk of default than most government and corporate bonds. Over the last six months, the panic sale in this market has wiped out one-third of investors' wealth. When the crisis worsens, companies will control construction activities and banks may refuse to provide funds to rebuild their sick balance sheets.

Chinese households are becoming more cautious about getting new mortgages. Household debt has already increased from $2 trillion to over $10 trillion over the past year. Income is rising relatively slowly, and thus households may take a backseat. Oxford Economics analysts expect China's real estate recession to be contained, but demographic changes, high levels of vacant homes and severe debt may cause a crash in the real estate sector.

First, it can have a large knock-on effect on builders, a sign which is now manifesting itself in the economy. Emerging market portfolio manager Aayush Sonthalia told Axios that companies that say they can't repay their debt are more likely to increase in number. This distress can spread to parts of the global market, such as commodities and raw materials through import and export channels, as demand for building materials, automobiles and machinery declines. The Beijing conflict also affected the millions of people working there and shocked the economy. As a result, home sales have declined and construction activities

have been reduced. This further impacts automotive and retail sales. Therefore, if China buys less steel, it could have a further impact on the global economy due to a fall in the import of metals. As China's domestic demand declines, the most exposed economies will suffer the most. The economies of Chile, Brazil, Australia, South Korea, Taiwan, Malaysia and Vietnam are among these economies. The Federal Reserve had warned that problems in China's real estate sector could spill over into the US financial system. The stress in China's housing sector could put pressure on China's financial system and affect the US, it said in a financial stability report. It showed the magnitude of China's economic and global ties.

The crisis in China's real estate market can lead to unemployment, stock price plunges and deflation. All of these factors can limit global trade channels, as China will eventually have to limit trade with other nations to some extent. China is intertwined with the world economy, and the crash there could spread to other countries. However, the report considered that fallout at these levels was unlikely. China is likely to contain the crash, but to improve the depressed investor sentiment, China must act swiftly.

Some analysts hope that China's problems will remain in China, as the Xi Jinping administration aims to contain the problems before they damage the banking system. However, a recent report by UBS stated a worsening housing collapse could wipe out $1 trillion from the global market. The International Monetary Fund predicts that global economic growth will rise by 4.9% next year, but UBS predicts that the struggling Chinese real estate market will slow growth by 0.5%.

The Parallelism between Japan and China

China's loose policies starting from those implemented after the financial crisis of 2008 laid the foundations for the current housing bubble and further the Evergrande crisis. Many experts claim that the housing bubble might eventually become similar to Japan's "Lost Decades" where deflation was at an all-time high and the economic growth declined. In fact, Japan was relatively richer in the years it faced the housing bubble than China is today. At the same time, though China can suffer huge amounts of bad debts, the chances of the Evergrande Crisis becoming as large as the collapse of Japan's housing bubble are less.

However, there is a striking resemblance between Japan in 1990 and China today: a certain kind of growth has reached its saturation. China's working population has begun to fall, like Japan's working population had begun to fall in 1995. In both countries, a development model that is based on huge levels of investment and accumulation of physical assets only brought back diminishing returns later. China has a lot of lessons to learn from Japan in the aforementioned regard.

CONCLUSION AND RECOMMENDATIONS

Despite the number of measures Japan has taken, its stress with deflation continues to date. Despite the large number of theories that exist, so as to explain the causes behind it, experts have more or less failed to identify a single factor. From the rare policy of negative interest rate to quantitative easing, Japan has tried it all yet the outcomes have not been favourable. Therefore, it would be safe to say that Japan's chronic deflation is a consequence of multiple causes rather than a single factor. However, these factors may have varied effects. As can be seen in the case of South Korea, their right planning and implementation of effective policies helped them overcome this similar economic shortcoming. Hence, Japan should learn some crucial lessons from South Korea's experience while taking into account its unique economic characteristics. However, if such is the case, what measures can be taken to prevent prolonged deflation? This report would like to put forward the following recommendations-

i. Reform to combat the ageing population - Age is a major factor that has contributed heavily to escalating the economic problems of Japan as elderly people are more inclined towards saving.
ii. Reduction in the transfers from central to local governments- There is a lot of inefficient use of funds by local governments resulting in heavy losses and poor investment decisions. The central government should take more initiative and have greater control over the resources and use them wisely.
iii. Optimal mix of public and private funds- A well-structured policy with a judicious mix of public and private funds will help raise consumption significantly. Public funds help in social welfare while private funds can be used for earning good profits.
iv. A review of monetary policy goals- A proper review should be undertaken and the experience of other countries facing similar economic problems should be considered (for eg- South Korea) to arrive at better and more comprehensive policy goals.
v. Diversification of Japan's energy basket- The country should actively look into the diversification of its energy resources given its heavy dependence on oil and coal imports.

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