Takeo Hoshi: What the U.S. can learn from Japan's economic meltdown

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A financial sector poised at the brink, about to collapse into free fall and a government scrambling to save it.

Takeo Hoshi has seen this movie before and he knows that it can have a happy ending. In the 1990s Japan faced financial crisis that mirrors the one that has gripped the United States and Europe these past few months. After a few false starts and missteps, the Japanese economy recovered, but it took them close to a decade.

If it learns from the Japanese experience, the U.S economy should recover more quickly. For now, Hohi believes the U.S is moving in the right direction. He is especially impressed with U.S. Treasury Secretary Henry Paulson's recent decision to forgo buying bad debt and instead focus on recapitalization of the banking industry.

Hoshi is Pacific Economic Cooperation Chair in International Economic Relations at UCSD and a research associate at the National Bureau of Economic Research (NBRE) and at the Tokyo Center for Economic Research (TCER). And he is a leading authority on the financial crisis that devastated the Japanese economy in the 1980s.

Both the Japanese and U.S. financial crisis began with bad loans made to real estate ventures. When the bad debt accumulated, banks no longer had the funds to lend or invest.

There was one major difference. Japan was a savor nation; while the U.S. is a debtor nation, which means that U.S. has less room for error. "Japan had a lot more money to waste, and they did," he said.

Initially the Japanese government used asset management to purchase bad debt. The plan's effectiveness was limited, in part, because they did not purchase enough assets, nor did it help with recapitalization. Worse, it put pressure on banks to prop-up weak firms.


Takeo Hoshi

"Most large Japanese banks were only able to comply with capital standards because regulators were lax in their inspections. To facilitate this forbearance the banks often engaged in sham loan restructuring that kept credit flowing to otherwise insolvent borrowers that came to be known as "zombie firms," Hoshi has written.

They were worried about unemployment. In the end it did not produced jobs and weakened the entire economy. Unemployment is a concern, Hoshi acknowledges, but he believes it is better to provide money directly though unemployment insurance and job training.

The U.S. also began its bailout efforts with a plan to buy bad debt, but less than a month after the Troubled Asset Relief Program or TARP was announced, the government reversed course. Paulson realized it wasn't working. On Nov. 12 he announced that bailout package would be used to shore up the financial markets.

"Our assessment at this time is that this is not the most effective way to use TARP funds," Paulson said, while emphasizing that he would not rule out "target forms of asset purchase."

Hoshi thinks Paulson's decision to forgo buying bad assets and rely on recapitalization is a wise one. "Not only are they focusing more on capital injection, but are reportedly planning to further injections conditional on matching private funding," he said.

More importantly, the U.S. recapitalization plan dose not included insolvent banks as the Japanese plan did. Since the crisis began, the Federal Deposit Insurance Corporation, or FDIC, has closed 15 banks that were not adequately capitalized. "It is a lesson their learned from the savings and loan crisis in the 1980s, but one that Japan had to learn on it own," Hoshi said.

"You always need to ask why this company is not doing well. In most cases the answer is that the company is not working efficiently."

While he doesn't support coddling failing companies, in any sector financial or manufacturing, he does support a stimulus package and believes that tax cuts would be the best approach. This is not a time to raise taxes. The budget deficit is large. While this is not the time to ease the deficit, it shouldn't be ignored, either, according to Hoshi.

Despite its many mistakes, the Japanese government did avoid a free fall and was able to recover from the crisis. He is cautiously optimistic that the U.S. will do the same, although he warns that the $700 billion allocated by Congress may not be enough.
The $125 billon that the government has allocated to nine major banks represents only one percent of those banks assets. Before it is over, the financial crisis may cost the U.S. taxpayer many billions more.