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Take It From Japan: Bubbles Hurt

By MARTIN FACKLER

KASHIWA, Japan

FOURTEEN years ago, Yoshihisa Nakashima looked at this sleepy suburb an hour and 20 minutes from downtown Tokyo and saw all the trappings of middle-class Japanese bliss: cherry-tree-lined roads, a cozy community where neighbors greeted one another in the morning and schools within easy walking distance for his two daughters.

So Mr. Nakashima, a Tokyo city government employee who was then 36, took out a loan for almost the entire $400,000 price of a cramped four-bedroom apartment. With property values rising at double-digit rates, he would easily earn back the loan and then some when he decided to sell.

Or so he thought. Not long after he bought the apartment, Japan's property market collapsed. Today, the apartment is worth half what he paid. He said he would like to move closer to the city but cannot: the sale price would not cover the $300,000 he still owes the bank.

With housing prices in the United States looking wobbly after years of spectacular gains, it may be helpful to look at the last major economy to have a real estate bubble pop: Japan. What Americans see may scare them, but they may also learn ways to ease the pain.

To be sure, there are several major differences between Japan in the 1980's and the United States today. One is the fact that property prices rose much faster and more steeply in Japan, partly because speculators used paper profits from a booming stock market to invest in property, insupportably leveraging the prices of both higher and higher.

Another difference is that the biggest speculators in Japan's frenzy were deep-pocketed corporations, and they pumped up the commercial property market at the same time that home prices were inflating.

Still, for anyone wondering why even the possibility of a housing bubble in the United States preoccupies so many economists, it is worth looking at how the property crash in Japan helped to flatten that economy, which is second only to that of the United States, and to keep it on the canvas for more than a decade.

And as American homeowners contemplate what might happen if their property values fell -particularly if they fell hard - there are lessons in the bitter experiences of their Japanese counterparts like Mr. Nakashima.

JAPAN suffered one of the biggest property market collapses in modern history. At the market's peak in 1991, all the land in Japan, a country the size of California, was worth about $18 trillion, or almost four times the value of all property in the United States at the time.

Then came the crashes in both stocks and property, after the Japanese central bank moved too aggressively to raise interest rates. Both markets spiraled downward as investors sold stocks to cover losses in the land market, and vice versa, plunging prices into a 14-year trough, from which they are only now starting to recover.

Now the land in Japan is worth less than half its 1991 peak, while property in the United States has more than tripled in value, to about $17 trillion.

Homeowners were among the biggest victims of the Japanese real estate bubble. In Japan's six largest cities, residential prices dropped 64 percent from 1991 to last year. By most estimates, millions of homebuyers took substantial losses on the largest purchase of their lives.

Their experiences contain many warnings. One is to shun the sort of temptations that appear in red-hot real estate markets, particularly the use of risky or exotic loans to borrow beyond one's means. Another is to avoid property that may be hard to unload when the market cools.

Economists say Japan also contains lessons for United States policy makers, like Ben S. Bernanke, who is expected to become chairman of the Federal Reserve at the end of January. At the top of the list is to learn from the failure of Japan's central bank to slow the rise of the country's real estate and stock bubbles, and then its failure to soften their collapse. Only recently did Japan finally find ways to revive the real estate market, by using deregulation to spur new development.

Most of all, economists say, Japan's experience teaches the need to be skeptical of that fundamental myth behind all asset bubbles: that prices will keep rising forever. Like their United States counterparts today, too many Japanese homebuyers overextended their debt, buying property that cost more than they could rationally afford because they assumed that values would only rise. When prices dropped, many buyers were financially battered or even wiped out.

"The biggest lesson from Japan is not to fall into the same state of denial that existed here," said Yukio Noguchi, a finance professor at Waseda University in Tokyo who is perhaps the leading authority on the Japanese bubble.

"During a bubble, people don't believe that prices will fall," he said. "This has been proven wrong so many times in the past. But there's something in human nature that makes us unable to learn from history."

In the 1980's, Professor Noguchi said, the frenzy in Japan reached such extremes that companies tried to outbid one another even for land of little or no use. At the peak, an empty three-square-meter parcel (about 32 square feet) in a corner of the Ginza shopping district in Tokyo sold for $600,000, even though it was too small to build on.

Plots only slightly larger gave birth to bizarre structures known as pencil buildings: tall, thin structures that often had just one small room per floor.

As a result, Japan's property market in the 1980's was much more fragile than America's today, Professor Noguchi said. And when the market fell, it fell hard. Because of all the corporate speculation, the collapse wiped out company balance sheets, crippled the nation's banks and gave the overall economy a blow to the chin.

Since 1991, Japan has spent 11 years sliding in and out of recession. It is only now showing meaningful signs of recovering, with the World Bank forecasting that Japan's economy will grow by a solid 2.2 percent this year

Despite the differences, Professor Noguchi said he also saw parallels between Japan then and America now. Last year, as a visiting professor at Stanford, he said he read real estate articles in local newspapers that sounded eerily familiar. Houses were routinely selling for $10 million or more, he said, with buyers saying they felt that they had no choice but to buy now, before prices rose even further.

"It was déjà vu," Professor Noguchi said. "People were in a rush to buy, and at extraordinary prices. I saw this same haste psychology in Japan" in the 1980's. "The classic definition of a bubble," he added, "is people buying on false expectations about future prices, and buying with the hope of selling in the future."

Economists and real estate experts see other parallels as well. In the 1980's, the expectation of rising real estate prices made many Japanese homebuyers feel comfortable about taking on huge debt. And they did so by using exotic loans that required little money upfront and that promised low monthly payments, at least for a short time.

A similar pattern is found today in the United States, where the methods include interest-only mortgages, which allow homebuyers to repay no principal for a few years. Japan had its own versions of these loans, including the so-called three-generation loan, a 90- or even 100-year mortgage that permitted buyers to spread payments out over their lifetimes and those of their children and grandchildren.

But when property prices dropped in Japan, homeowners found themselves saddled with loans far larger than the value of their real estate. Many fell into bankruptcy, especially those who lost their jobs or took pay cuts as declining property prices helped to incite a broader recession. From 1994 to 2003, the number of personal bankruptcies rose sixfold, to a record high of 242,357, according to the Japanese Supreme Court, which tracks such data.

Even many of those who avoided financial collapse found themselves marooned in homes that they never intended as lifelong residences. For many Japanese homebuyers in the 1980's, land prices had risen so high that the only places they could afford were far from central Tokyo. Many went deep into debt to buy tiny or shoddily built homes that were two hours away from their offices.

Now, after years of tumbling land prices have made Tokyo more affordable again, few people are shopping for homes in the distant suburbs. That has led to severe declines in property values in these outlying areas, leaving many people with homes that are worth less than the balance on their mortgages from a decade or more ago.

Mr. Nakashima, who bought the apartment here in Kashiwa, said it would take him at least another decade to whittle down his loan to the point that he could pay it off by selling his home. And this assumes that the apartment does not drop further in value - a real possibility, because lower prices in Tokyo have led to a recent boom in construction of newer apartments in neighborhoods closer to downtown.

"We can't sell and get something better because we'll take such a huge loss," said Mr. Nakashima, a serious man who recounts his story with careful precision, sometimes pausing to check dates. "The collapse of the bubble robbed us of our freedom to choose where we can live."

He rues the idea that homes came to be seen as just another investment. "Homes should be different from stocks," he said. "They shouldn't be the object of speculative investing. If home prices move too much, they can ruin your life."

Mr. Nakashima says he is resigned to spending the rest of his days in Kashiwa. It is peaceful here, after all, he said. There is also a bit of history: he pointed to two tree-covered mounds in a corner of the apartment complex that are said to contain the severed heads of samurai killed in a battle here five centuries ago.

Some economists say that there are probably millions of people like Mr. Nakashima, trying to make the best of life in homes that are distant from work and for which they grossly overpaid. "There is a whole generation of homebuyers stuck out in far suburbs," said Atsushi Nakajima, chief economist at the research arm of the Mizuho Financial Group in Tokyo. "It's sad, but Japan has basically forgotten about them, and is moving on. They are just left out there."

Mr. Nakajima said he had barely missed being stuck out there himself. In 1991, he was looking at a 100-square-meter apartment (1,080 square feet) for about $600,000 about two hours outside Tokyo. He said his wife stopped him. Six years later, he spent the same amount to buy a more spacious house in a downtown neighborhood. "Maybe my wife should be the economist," he said.

Now that Japan's real estate market is finally showing signs of recovering from the 1991 collapse, economists say it offers a lesson for Americans in how to end - and not to end - a long slide in property prices.

For years after the real estate bubble burst, the Japanese government tried to resuscitate the market and other parts of the economy with expensive public works projects, but they were so poorly planned that they succeeded only in inflating the national debt.

NOT until the late 1990's did the government try a new tack: deregulation. To kick-start the economy, Tokyo started loosening restrictions on the financial industry. While most of this effort was aimed at reviving the banking industry, it also allowed investors to create real estate investment trusts, essentially mutual funds that invest in commercial property. A few years later, the government also eased building codes, such as height limits, and cut approval times for building permits.

Economists and real estate executives credit these changes with bringing new money into the market, and with making redevelopment easier. The results are visible in a boom that is dotting the Tokyo skyline with cranes and new high-rises.

They are also visible in statistics. Residential home prices in Tokyo rose 0.5 percent in the 12 months through July, the first gain in 15 years, the government said in September. Nationwide, land prices are still down, but the pace of decline has slowed to a crawl, the government said.

"Deregulation revived the Tokyo land market," said Toshio Nagashima, executive vice president at Mitsubishi Estate, one of Japan's largest real estate companies. He said the changes were one reason that his company committed to spend $4.5 billion by 2007 to build six skyscrapers in the central Marunouchi financial district.

Japanese economists say the United States is not likely to suffer a decline that is as severe or long-lasting as Japan's, because they see a more skilled hand at the tiller of the American economy: the Federal Reserve. Japan's central bank, the Bank of Japan, failed to curb the stock and real estate bubbles until mid-1989, when it was too late and prices were sky-high, they said.

When it did take action, it moved faster and more drastically than Japan's overinflated land and stock markets could handle, raising its benchmark interest rate to 6 percent from 2.5 percent over 15 months. Economists say that this pulled the rug out from under both markets at the same time.

Akio Makabe, a finance professor at Shinshu University in Matsumoto, says the Fed has been more deft in handling the rise in America's property market, which he believes is definitely in a bubble. He praised the Fed for apparently learning from Japan's mistakes, tightening more gradually and taking the economy's pulse as it does so.

"Japan shows the importance of avoiding a hard landing," Professor Makabe said. "Avoid big shocks. That is the biggest lesson of Japan's bubble."

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