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The Formation of the Bubble Economy in Japan: the 1980s

During the late 1980s the prices of assets such as shares and land soared, triggering a full-blown bubble economy. This case study describes how the 1980s international trade environment surrounding Japan, and Japan-U.S. relations in particular, led to the formation of the bubble economy[1].

The Stagflation of the 1970s

The key economic events of the 1970s that influenced the international economy of the 1980s were the switch to floating exchange rates following the Nixon Shock of 1971 and the oil crises of 1973 and 1979.

To begin with, in August 1971, then U.S. President Nixon unilaterally announced the termination of direct convertibility of the U.S. dollars to gold. The Bretton Woods system of monetary management that had existed until then was based on the ability to exchange the U.S. dollars for gold at a fixed rate, having other countries fix the exchange rates of their currencies into the dollars in advance. With the Nixon Shock, however, the Bretton Woods system virtually ended.

Attempts were then made to re-establish the system of fixed exchange rates at new rates. In December 1971, the Smithsonian Agreement set new and lower fixed rates for the dollar. In 1973, however, the U.S., Britain, and most other developed countries switched to a system of floating exchange rates, sounding the final death knell to the Bretton Woods system.

Under the Bretton Woods system, rates of exchange of the dollar into other currencies were fixed. In the late 1960s, however, confidence in the dollar declined, and Japan began intervening in the foreign exchange market, buying the U.S. dollars and selling yen in order to maintain the fixed rate[2]. The yen selling flooded the market with yen, leading to a sharp increase in Japan's money

This case study was prepared (in November 2011) by Shinji Azuma and Professor Hiroshi Nakamura of the Graduate School of Business Administration, Keio University, based on publicly available information as well as suggestions and comments from Professor Shigeru Tanaka of the same graduate school, and was designed to be used as a basis for class discussions.
The English version was translated under supervision of Hiroshi Nakamura of the Graduate School of Business Administration, Keio University.
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[1] "Bubbles" has a long history, with the tulip mania of the 17th century in the Netherlands being particularly famous. Once tulip bulbs started being targeted by speculators, their prices soared, to the extent that a single bulb could be exchanged for a horse or a carriage.

[2] The dollar purchases were designed to maintain the value of the dollar.