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Article

Bank lending and economic activity in Japan: did ‘financial factors’ contribute to the recent downturn?

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Abstract

In this paper, we examine the role of ‘financial factors’ in Japan and attempt to gauge their recent impact on the Japanese economy. First, we find that proxies for financial factors enter significantly in behavioural equations for loan standards, loan demand, and aggregate demand. Second, we find strong evidence that financial factors contributed to Japan's recent recession. On the loan supply side, exogenous declines in equity prices appear to have led to a sharp increase in bank loan standards and a substantial subsequent decline in loans and economic activity. We also find some evidence that an exogenous contraction in loan supply may have lowered output by a small degree, but only in the early phases of the recession. On the loan demand side, asset price declines also led firms and households to sharply reduce their demand for bank loans and goods, although it is unclear how much this influence may reflect traditional wealth effects. In addition, loan demand shocks, which could reflect balance-sheet problems not captured by our model, account for much of the remainder of the shortfall in loans. © 1998 John Wiley & Sons, Ltd.