Advice *From* Tokyo

How can America avoid repeating Japan's past policy blunders? Here are six recommendations.

BY RICHARD C. KOO

President Obama, like other Western leaders, is confronted with deep-seated disagreements over the right direction for economic policy. Some argue for more monetary stimulus in the form of a third round of quantitative easing, while others warn that such efforts will trash the dollar. Some push for more fiscal stimulus, while others denounce big government as the source of the problem. Some call for a quick disposal of bad assets in the banking system, while others recommend "pretend and extend" policies to keep the real estate market from collapsing. With so little agreement even among the experts, it is no wonder that our political system is gridlocked. This is not a crisis of leadership; it is a crisis of economics.

ROOT CAUSE OF DISAGREEMENTS: A HIGHLY UNUSUAL RECESSION

Those in Washington may be relieved to know that the same policy debate was taking place in Tokyo fifteen years ago, with similar levels of animosity and confusion. Although any comparison with Japan tends to elicit an outpouring of denial from the United States along the lines of "it cannot happen here" and "Japan is different because of its high savings rate," the two nations are experiencing exactly the same problem fifteen years apart. In both cases zero interest rates, quantitative easing, and large fiscal stimuli failed to get the economy back on track. And it took many years for those of us in Japan to discover that the economy was actually suffering from a highly unusual recession, now known as a balance sheet recession, which has seldom been anticipated by the economics profession.

Unlike ordinary recessions, which result from the business cycle or monetary tightening to curb inflation, balance sheet recessions are triggered by the bursting of a nation-wide, debt-financed asset price bubble. When such a bubble bursts, asset prices collapse but liabilities remain, leaving millions of

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private-sector balance sheets underwater. Households and businesses are then forced to minimize debt in order to repair their balance sheets and restore their financial health and credit ratings. Although that represents the right course of action for individual businesses and households, the economy experiences a continuous loss of aggregate demand when everyone deleverages at the same time.

The first casualty of this shift to debt minimization is monetary policy, the traditional remedy for recessions, because people with negative equity are not interested in borrowing more at any interest rate. Nor will there be many willing lenders, especially when the lenders themselves have balance sheet problems. That is why zero interest rates and quantitative easing policies in Japan and the United States have failed to turn the two economies around.

More importantly, when the private sector is deleveraging in spite of zero interest rates, the economy enters a deflationary spiral which typically ends in depression. To see this, consider a world where a household has an income of $1,000 and a savings rate of 10 percent. This household would then spend $900 and save $100. In the usual or textbook world, the saved $100 would be taken up by the financial sector and lent to the borrower who can make best use of the money. When that borrower spends the $100, aggregate expenditure totals $1,000 ($900 plus $100) against original income of $1,000, and the economy moves on. When demand for the saved $100 is insufficient or excessive, interest rates are lowered or raised to ensure that the full $100 is borrowed and spent in the end.

In a world where the private sector is minimizing debt, however, there will be no borrowers for the saved $100 even at zero interest rates, leaving the economy with only $900 of expenditure. That $900 represents someone's income, and if that person saves 10 percent, only $810 will be spent. But since repairing balance sheets after the collapse of a major bubble typically takes a long time (it took fifteen years in Japan), the saved $90 will go unborrowed again, and the economy will shrink to $810, and $730, and so on. This is exactly what happened during the Great Depression, when the United States lost 46 percent of its GDP in just four years due mostly to a deflationary spiral induced by debt repayments.

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Because monetary policy is largely ineffective in this type of recession, the only way for the government to stop the deflationary spiral is to borrow and spend the $100 that was saved. That way, total expenditure will remain at $1,000 and there is no reason for the economy to shrink. By keeping the economy from contracting, this also provides income to the private sector so that it can pay down debt.

Japanese businesses, which were borrowing and investing 12 percent of GDP at the peak of the bubble in 1990, were paying down debt to the tune of 10 percent of GDP by 2003. In effect, Japan lost aggregate demand equal to 22 percent of GDP because of corporate deleveraging. But the Japanese government managed to keep GDP at above the bubble peak throughout this period by borrowing and spending the aforementioned $100. This fiscal action kept the unemployment rate from rising above 5.5 percent and allowed the private sector to finish paying down debt by 2005. Although it increased government debt by ¥460 trillion, or 92 percent of GDP, between 1990 and 2005, it was actually a tremendous bargain because it managed to sustain over ¥2,000 trillion in GDP compared with a depression scenario.

The U.S. private sector, which was borrowing and investing 5 percent of GDP in 2008, is now saving (including debt repayments) a net 6 percent of GDP in spite of zero interest rates, just like the Japanese a decade ago. This means the United States is now squarely in a balance sheet recession and needs substantial and sustained government spending to prevent a deflationary spiral from taking hold. More worryingly, U.S. GDP has already fallen below its bubble peak, especially when viewed on a per capita basis, and the unemployment rate is still over 8 percent.

RECOMMENDATION 1: EXPLAIN

The first thing President Obama should do in this situation is to explain to the American people that the United States has contracted a different kind of disease. Drawing on the $1,000 to $900 to $810 example presented above, he should explain that what may be the right course of action for individual households and businesses can wreak havoc on the broader economy when that action happens to be debt repayment. Since it is the American people themselves who are paying down debt, this should be relatively easy for them to understand. A twenty-minute airtime on national television should do it. Once the public realizes that the private sector has no choice but to continue repairing its balance sheet and that the government therefore needs to step in and help, the President should be able to win support for the fiscal stimulus needed to stabilize the economy.

RECOMMENDATION 2: SUSTAIN THE STIMULUS

The second thing the President should do is to explain that fiscal stimulus must be sustained until private sector financial health is restored. The logic here is simple: removal of the aforementioned $100 will start the $1,000 to $900 to $810 deflationary spiral if the private sector is not ready to resume borrowing. Indeed, premature fiscal consolidation by the Japanese government in 1997 when the private sector was still deleveraging resulted in five quarters of negative growth and increased the deficit by 68 percent, from ¥22 trillion in 1996 to ¥38 trillion in 1999. It took Japan ten years to climb out of the hole created by this policy error. Japan would have come out of its balance sheet recession much faster and at a significantly lower cost than the ¥460 trillion noted above if it had not implemented the austerity measures in 1997. The United States made the same mistake of premature fiscal consolidation in 1937, with equally devastating results. In this type of recession it is always better to err on the side of too much fiscal stimulus rather than too little since the latter can prompt a destructive deflationary spiral.

RECOMMENDATION 3: MAKE CONCESSIONS

The third thing the President should do is to offer Republicans an equal share in new spending programs and suspend temporarily all talks on fiscal consolidation, including his insistence on raising taxes on the rich. Fifty percent of any new spending should be decided by the Democrats and 50 percent by the Republicans. This concession is needed to get the stimulus in place as quickly as possible. Although many ordinary Americans may find tax breaks for the rich unpalatable, today is not the time to be hitting the brakes and the accelerator simultaneously. With so many people still unemployed and the President's earlier fiscal stimuli expiring, a new package is urgently needed.

RECOMMENDATION 4: PROMISE FUTURE BALANCE SHEET REPAIRS

The fourth thing the President should do is to assure the people that once the private sector has finished repairing its balance sheet, the public sector will do the same. It would be best if this were presented in the form of a social contract whereby the government assured the public that it will sustain GDP with fiscal stimulus for, say, the next five years, during which time businesses and households are expected to finish repairing their balance sheets. After that, the government will begin cutting spending and raising taxes, including those on the rich, to repair its balance sheet. Such a contract would allow the private sector to concentrate on repairing its balance sheet by eliminating the possibility of an unexpected shift in fiscal policy and economic conditions.

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RECOMMENDATION 5: DEFEND THE DOLLAR

The fifth thing the President should do is to assure investors that he will defend the dollar and expects the Federal Reserve to do the same. This is needed to quell the perennial fear abroad, especially among those holding large quantities of Treasury securities, that when push comes to shove the United States will try to inflate its way out of its problems by trashing the dollar. As long as foreign investors are confident that the United States will maintain a disciplined currency policy, a larger fiscal stimulus need not trigger a market backlash because investors will understand the need for such stimulus.

Despite all the warnings about a "bond market rebellion" from fiscal hawks, bond prices have climbed to record levels alongside the largest budget deficit in peacetime. The same phenomenon occurred in Japan over a decade ago and in the United Kingdom today. This is the norm in a balance sheet recession because when the private sector as a whole is deleveraging, fund managers who must invest those deleveraged funds in assets with a principle guarantee and without foreign exchange risk are forced to buy their own government's bonds, pushing prices higher. (This principle does not apply to the eurozone, where a Spanish fund manager can buy German government bonds, depriving the Spanish government of the domestic savings needed to fight the balance sheet recession. This kind of capital flight is unique to the eurozone and is the root cause of the fiscal and financial crisis there.) The fact that the U.S. and UK bond prices are approaching Japanese levels suggests that bond market participants are already aware of the reality of balance sheet recessions.

RECOMMENDATION 6: EXPECT CRITICISM

The President should be aware that none of the above actions will make him a hero. The above recommendations are all designed to avert crisis, but those who avert crisis by taking preemptive actions never become heroes; a hero is created only after the crisis has happened. All Hollywood

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