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Japan's Lost Decade: Lessons for the United States in 2008

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Japan experienced a disastrous decade of economic stagnation and deflation from 1991 to 2001 after bubbles in its stock market and land market collapsed. While some economic pain was unavoidable—given a 60 percent plunge in equity prices between late 1989 and August 1992, accompanied by the onset of what ultimately became a 70 percent drop in land values by 2001—the "lost decade" was not an inevitable outcome. It required a series of persistently wrong economic policy decisions that ignored the lessons learned in America's Great Depression of the 1930s and the subsequent research on the causes of that painful period.

Japan's experience in its lost decade and, indeed, during the new millennium carries with it lessons for U.S. policymakers today after the collapse of America's highly leveraged housing bubble that has already seen prices drop by more than 10 percent from their 2006 peak, with indications of another 10 to 15 percent fall. America's stock market is about 15 percent below its October 2007 peak, suggesting that investors are currently expecting a mild U.S. recession. More ominously, however, credit markets have largely ceased to function, save for the highest quality loans, suggesting that a sharp reduction in the quantity of credit available at market-clearing interest rates is threatening to curtail real economic activity by more than the seemingly benign level of market interest rates would suggest.

U.S. Credit Crunch

The United States is experiencing an intensifying lack of credit availability that is causing a sharp economic slowdown—until recently unforeseen by most economists, including those at the Federal Reserve. This is understandable—though not comforting—because most economic models capture the link between financial markets and the real economy with movements in the level of interest rates. A credit crunch in which interest rates do not move much but credit becomes severely restricted is difficult, if not impossible, to model accurately.[1] The result: weaker-than-expected growth during a period of rapid Fed easing. The federal funds rate was cut by 225 basis points—from 5.25 percent to 3 percent between August 17, 2007, and January 30, 2008. Fourth-quarter growth, at an annual rate of 0.6 percent, was sharply lower than the 4.9 percent third-quarter growth rate. First-quarter 2008 growth will probably be negative.

Many sectors of U.S. credit markets are frozen because transactions at market-clearing prices and interest rates would imply asset prices substantially below levels being assumed in financial reports prepared by banks, investment banks, insurance companies, and other financial institutions. A fear of solvency problems is constraining liquidity. Beyond that, accounting convention calls for valuation of real estate–related assets based on current real estate prices, not expected (lower) future prices. This convention amounted to a conservative assumption when prices were rising, but it is unrealistic when prices are falling. It results in expectations that upcoming financial reports will show further deterioration of balance sheets. The distribution among financial institutions of balance sheet deterioration is uncertain, and so investors require a higher risk premium on

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returns on mortgage-based and complex derivative securities, virtually all of which are exposed to falling prices of residential real estate. The problem may grow worse as commercial real estate prices come under pressure, in turn, from an intensifying credit crunch.

Despite a tightening credit squeeze that is resulting in a sharp slowing of U.S. growth to recession levels, there is no reason to suppose that the United States is headed for a lost decade like Japan's. Prompt, aggressive easing by the Fed, along with a clear recognition that deteriorating credit and economic conditions may require further easing, constitutes a vital first step toward avoiding a prolonged recession that brings with it the danger of deflation. It is deflation that was immensely damaging to Japan after 1998 and continues to be a threat there today. Fed chairman Ben Bernanke was clear in his February 14 testimony before the Senate Banking Committee on the economy and financial markets that he recognizes the risks posed to the economy by deteriorating credit markets: "It is important to recognize that downside risks to growth remain, including the possibilities that the housing market or the labor market may deteriorate to an extent beyond that currently anticipated or that credit conditions may tighten substantially further."

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Beyond prompt Fed action to reduce interest rates, prompt enactment of a fiscal stimulus package (equal to about 1 percent of GDP), including about $100 billion of tax rebates to households at midyear and an estimated $50 billion of investment incentives, will help—other things being equal—to add as much as half a percentage point to 2008 growth. The risks are to the downside for the growth boost because households, unnerved by falling house prices and stocks and by curtailment of available credit, may choose to save their rebates.

Lessons from the Lost Decade[2]

The issues and alternatives facing U.S. policymakers as they attempt to reopen credit markets and restore growth—as well as the pitfalls to avoid—are well illustrated by Japan's experience in the 1990s. The primary lesson is to acknowledge and confront the problems created for banks and other financial institutions by the ongoing drop in the real estate markets.

Japan's lost decade can be divided into three sections: the 1991–93 recession, the temporary recovery of 1994–96, and the deep recession of 1997–99. Each episode offers important lessons.

The post-1989 collapse of Japan's equity bubble was, at first, welcomed by the Bank of Japan. Even though stock prices were falling rapidly, land prices continued to rise for another year at least, and the Bank of Japan remained concerned about inflation pressures. The Bank of Japan actually boosted the discount rate from 4.75 percent to 6 percent in August 1990 and held it at that level until June 1991. As the collapse of equity prices intensified and land prices began to fall, the Bank of Japan reversed course and cut its discount rate rapidly by 275 basis points in the year following June 1991. Subsequent additional cuts of 150 basis points in 1993 brought the discount rate down to 1.75 percent by September 1993. Simultaneously, Japan pursued three major fiscal stimulus packages totaling 6 percent of GDP between August 1992 and September 1993.

The effects on the economy of these extraordinary stimulative measures were limited. Growth recovered only slightly—to just over 1 percent in 1994—for several reasons. First, the Bank of Japan was late to initiate its easing. By the time of the first rate cut in June 1991, Japan's nominal GDP growth, which in the long run should not be allowed to fall below policy interest rates, had dropped to about 2.5 percent, headed down to a negative level by 1994. That level was far below the 6 percent discount rate in place. Simultaneously, falling land and equity prices were erasing household wealth and resulting in a sharp curtailment of credit because of the heavy exposure of Japan's banks to the commercial land bubble. This was especially damaging because Japanese companies are far more reliant on banks for financing than American companies, which have access to broader credit markets.

More broadly, deflation began to emerge, which boosted real growth numbers artificially. (Real growth is calculated by subtracting inflation from nominal growth or adding deflation to nominal growth.) Real growth of 2 percent, generated by zero nominal growth and 2 percent deflation, is too weak.

Japan's large fiscal stimulus packages, which became legendary during the 1990s, were ineffective for several reasons. First of all, the packages were not as large as advertised, often inflated by double counting as stimulus government programs that were already slated to be undertaken. More importantly, the packages were poorly directed—largely toward unproductive public works projects and credits to small businesses that were no longer economically viable. It would have been far better to have reduced tax rates and allowed households to employ the increase in disposable incomes as they saw fit. Investment incentives would have helped as well, since part of the aftermath of the stock market boom was a collapse in private investment following the excessive buildup that occurred in the 1980s. Also, the need to move production facilities abroad grew as the economic environment in Japan deteriorated and deflation strengthened the yen, making goods produced in Japan too expensive in world markets.

Japan's sharp interest rate reductions and sizeable public works programs did help to boost the economy mid-decade. The real growth rate reached nearly 4 percent in 1996 and early 1997. Yet an ominous period of deflation that emerged mid-decade and dragged down nominal GDP growth was largely ignored by Japan's policymakers. The deflation, coupled with a loss of public confidence tied to the Kobe earthquake in January 1995, resulted in an elevation of liquidity preference by Japanese households and firms.

The sharp rise in the demand for money was signaled by a rapid appreciation of the yen, which reached 79.8 per dollar on April 19, 1995. As Japanese households sought to raise cash balances, Japan's external surplus created a strong demand for yen that was not offset by capital outflows. The sharp appreciation of Japan's yen early in 1995 signaled a severe liquidity shortage, which resulted in a sharp drop in demand, even though market interest rates were low. In 1995, Japanese policymakers responded with another 125 basis points of rate cuts that brought the discount rate to 0.5 percent in September of that year. Another two major fiscal stimulus packages in 1994 and 1995, again totaling 6 percent of GDP, helped to sustain a recovery of growth until 1997.

Don't Raise Taxes

Japan's biggest policy mistake came in 1997 when the government raised its consumption tax from 3 to 5 percent. The aim was to help compensate for the large run-up in Japanese debt that resulted from the series of unproductive fiscal stimulus packages expended largely on wasteful public works projects. The combination of higher consumption taxes, the continued fall in land prices that persisted in preventing Japan's banks from operating as financial intermediaries because of their heavy exposure to real estate losses, and a rapid return to deflation in 1998 resulted in a virtual collapse of the Japanese economy.

Japan's poorly timed attempt to redress its large budget deficit and rapidly rising public debt provided a compelling reminder of the lessons that John Maynard Keynes taught in the *General Theory of Employment, Interest, and Money*.[3] Fiscal stringency in the form of a tax on consumption in an economy weakened by massive wealth losses and an erosion of confidence that results in a virtual liquidity trap is an extraordinarily harmful policy. Japan's nominal GDP growth rate was below zero for most of the five years after 1997, with most of its positive real growth resulting from the technical application of GDP deflators averaging about –1.5 percent. In a deflationary economy, it is important to watch nominal, not real, GDP growth.

An economic cycle driven by a collapse in the market for an asset—such as land or housing—to which the banking system is heavily exposed is a dangerous beast.

Japan persisted in believing that monetary policy was extremely accommodative because of low nominal interest rates and the Bank of Japan discount rate at 0.5 percent. But with deflation at 1.5–2 percent and negative nominal GDP growth, a 0.5 percent interest rate was actually restrictive.

Japan Reflates

After five years in a deflationary economic wilderness, t he Bank of Japan switched during the spring of 2001 to a policy of quantitative easing—targeting the growth of the money supply instead of nominal interest rates—in order to engineer a rebound in demand growth. Simultaneously, the energetic and innovative Junichiro Koizumi was elected prime minister in April 2001, and he undertook aggressive measures to recapitalize Japan's banks, which were still heavily burdened by nonperforming loans.

The need to recapitalize Japan's financial sector had been evident since late 1997 when Yamaichi Securities—a midsized Japanese securities house—collapsed, followed by failures of some regional banks in 1998. The persistent problem was nonperforming loans whose total value rose as high as 20 to 25 percent of Japanese GDP. While substantial public funds had been made available to Japanese banks in 1999, balance sheet restructuring was undertaken only slowly and reluctantly, partly because of the stigma attached to revealing long-concealed losses and fears of losing control to foreign investors. A lack of transparency in the balance sheets of Japanese banks and a passive approach by the Japanese government to restructuring those balance sheets contributed substantially to the prolonged period of economic stagnation. Deflation exacerbated the problem by further depressing the land prices to which Japan's balance sheets were closely tied and by elevating real interest rates. When cash—a riskless asset—was earning the deflation rate of 2 percent or higher, few wanted to leave their deposits in banks whose solvency was in question because of heavy exposure to the collapse in land prices and that offered interest rates to depositors that did not compensate for those perceived risks.

The move by the Bank of Japan to quantitative easing and the large increase in liquidity that followed helped to stabilize land prices by 2003. The Japanese economy has, since then, enjoyed modest growth averaging around 2 percent per year, while deflation has moderated but not disappeared. The Bank of Japan held interest rates at zero until early 2007, when it boosted its discount rate back to 0.5 percent in two steps by midyear. Since then, however, the slowdown in global economic activity and persistent deflation have stayed the Bank of Japan's hand from further rate increases and raised the possibility of even returning to rate cuts in 2008 as the outlook for the Japanese economy becomes cloudy.

Prompt policy interest rate reductions by the central bank and some fiscal relief for households and firms are necessary but not sufficient conditions to return the economy to health.

Lessons for America

A detailed examination of Japan's lost decade may lead some to conclude that America's current problems are not that serious. The lessons for American policymakers in 2008, however, are clear, and it would be unwise to ignore them. An economic cycle driven by a collapse in the market for an asset—such as land or housing—to which the banking system is heavily exposed is a dangerous beast. One lesson that we shall probably be learning this year is that conventional measures like prompt policy interest rate reductions by the central bank and some fiscal relief for households and firms are necessary but not sufficient conditions to return the economy to health.

The banking system must move promptly (or be moved promptly) to reveal the full extent of its exposure to the depreciating asset—U.S. real estate, in this case. If market-clearing prices for financial assets tied to real estate entail substantial losses for financial institutions, those losses must be taken by shareholders. If shareholder equity is insufficient to protect depositors, then public funds must be used to provide that protection in the form of additional equity capital for banks in order to avoid a further collapse in asset values entailed by rapid withdrawal of funds from financial institutions.

Usually, to return banks and other financial intermediaries to operational status requires a public fund that purchases impaired assets from financial institutions. The prices paid for those assets are then well-established and provide a definite base from which to evaluate the condition of the balance sheets of financial intermediaries. With that accurate information, at least the risk premium tied to uncertainty about the distribution and degree of losses tied to real estate–based financial assets is reduced. Meanwhile, the assets purchased by the public entity can be held off the market until economic expansion returns and they can be auctioned off to private investors—hopefully at a profit. This was the experience in the early 1990s after the U.S. government set up the Resolution Trust Corporation to deal with the insolvency problems of the savings and loan industry. The process is difficult and contentious, but the cost of a prolonged delay in undertaking it can be substantial, as Japan's experience in the 1990s amply demonstrates.

There are two other important lessons from Japan's lost decade. The first is: do not allow deflation to take hold. While higher commodity prices have most central banks concerned that inflation pressures may rise, it is important to remember that incipient inflation can quickly turn to incipient deflation if a sharp contraction in world economic activity depresses commodity prices at the same time that prices of finished goods and services are falling.

Right now, the operational counterpart of avoiding deflation is simply for central banks to take the position that a credit crunch and a rapidly slowing economy suggest that inflation pressures will abate and that more emphasis should be placed on avoiding a sharp growth slowdown. The Federal Reserve clearly holds this position, but the European Central Bank does not. However, actions taken by the Fed to push interest rates down still further, as the U.S. economy slows, will probably cause the dollar to weaken. If it weakens enough as global activity is slowing, that will likely push the European Central Bank to reconsider its reluctance to reduce interest rates.

The second additional lesson from Japan's 1990s experience is to avoid the temptation to raise taxes in the midst of a rapid economic slowdown driven by deteriorating credit conditions. While it is true that budget deficits and the national debt will be increased by stimulative fiscal measures and, more profoundly, by the loss of revenues that accompanies a sharp economic slowdown, a premature tax increase such as Japan executed in 1997 can throw a weak economy back into a more intense slowdown that only exacerbates the problems already present. Japan's experience amply demonstrated that fiscal deficits on the order of 3 or 4 percent of GDP and a government debt well above 100 percent of GDP, while burdensome, do not result in higher interest rates in an economy struggling to maintain stable, nondeflationary prices and modest growth.

Japan's movement out of its decade of negative growth and deflationary pressures in the early part of the millennium relied heavily on close examination of U.S. policy measures and advice from U.S. policymakers. We should hope that whoever is elected president this November will not ignore the lessons of Japan's last decade when it comes to examining options on tax policy. Revenue-neutral reductions in marginal tax rates—more things taxed at lower rates—is the best policy alternative. Further subsidies to already oversubsidized sectors of the American economy—like real estate—would be unwise. The extensive subsidies for the real estate sector constitute part of the problem we are now facing, not a desirable part of the solution.

Although America is entering a difficult recession driven by credit problems tied to rapidly falling real estate values, we have the knowledge and the means to engineer a return to normal growth by late 2009. The main requirement is the courage to acknowledge the scope of the problems we are facing and to undertake measures to address those problems directly, including movement to more transparency on the scope and distribution of distressed financial assets linked to real estate. Japan's experience in the 1990s, while painful, provides helpful guidance and a compelling reminder that the worst approach to dealing with the unusual set of problems we currently face would be to deny that they exist.

Notes

1. Goldman Sachs has reported some success. See "Lessons from Past Credit Crises," *U.S. Economics Analyst*, no. 08/07 (February 15, 2008).

2. This section draws on two, more complete discussions of Japan's lost decade. See John H. Makin, "Japan's Disastrous Keynesian Experiment," *Economic Outlook* (December 1996); and JPMorgan, "Lessons for Today from Japan's Woes of the 1990s," *Global Data Watch* (February 8, 2008): 11–14.

3. John Maynard Keynes, *General Theory of Employment, Interest, and Money* (New York: Palgrave Macmillan, 1936).